INTERNATIONAL ACCOUNTING HARMONIZATION

ADOPTING UNIVERSAL INFORMATION METHODS FOR A GLOBAL FINANCIAL SYSTEM

JENO BEKE

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1. Introduction

Nowadays, especially during the current global financial crisis, companies are striving desperately to remain competitive and achieve sustainable levels of economic development. The highly competitive environment requires companies to create a clear business strategy, and accounting has to be part of this strategy since it helps individual enterprises to achieve their strategic objectives. International accounting standards are new global methods for business information systems and they are able to harmonize financial regimes worldwide. The increased globalization of markets, the complexity of commercial trading, and the concentration of business in global competition have led to a still greater need for international harmonization.

In today's business environment, companies need to make use of every advantage available to remain competitive. Global competition, rapid innovation, entrepreneurial competitors, and increasingly demanding customers have altered the nature of competition in the marketplace. This new competitive environment requires companies' ability to create value for their customers and to differentiate themselves from their competitors through the formulation of a clear business strategy. Business strategy must be supported by appropriate organizational factors such as effective manufacturing process, organizational design, and accounting information systems.

Modern business environments are increasingly competitive and dynamic. International competition through e-commerce and demand-based supply chain management dominates business. It is important for companies to develop coherent and consistent business strategies and to utilize management accounting tools to support strategic planning, decision-making, and control. To integrate business strategies with various management accounting tools, first companies need to identify the business they are in. It is essential to identify products and services, customer types, geographical markets, and delivery channels. It is useful to match the strategic business unit (SBU) with the related business unit strategy. An SBU is a company department or subsection that has a distinct external market for goods or services that differ from another SBU. A business unit strategy is about how to compete successfully in particular markets. It is important to focus on a certain segment, such as economically useful cars in the automobile industry or Internet and phone banking in the retail banking sector.

The financial crisis is also encouraging more critical examinations of the managerial innovations that have emerged from the audit industry, not least its pursuit of the bureaucratization of risk in the name of risk management. From the analysis of a crisis where risks have been real and perceived, it is increasingly becoming apparent that risk management mechanisms do relatively little to facilitate real management of risk. Adding as they do to costs—and the income of the consultancies involved—by isolating rather than integrating the management of risk, the bureaucratic mechanisms still promoted by the audit firms and their associates provide yet further evidence of the relatively limited understanding that the audit industry has of real time management in action.

Trying to understand the crisis and reflect on its implications also illustrates the dangers of the drift away from the world of accounting practice that has been a characteristic of so much accounting research for the last few decades. Indeed at times it is possible to think that for some there has been a drift away from accounting itself: at the very least there has been a pronounced move toward studying accounting at a distance. As yet this has not been as severe in its implications as for those of our colleagues in finance research, where increasing numbers have a very limited appreciation of the complexities of practice and its institutional context. Nevertheless, there has been a move away from analyzing just such complexities and institutional contexts in the accounting area, often in the name of theoretical elegance and methodological rigorous. Interestingly this is true for both statistically based capital market studies and a great deal of more critical theorizing. Of course theoretical and methodological issues are of real importance, not least in helping to avoid methodological capture by practice norms, frameworks, and ways of looking at the world. But as numerous other social science disciplines illustrate, there are ways of balancing interests in the need for sound and reliable research with genuine interests in the complexities of practice. It really is important to understand how accounting has become implicated with the creation of new financial practices, with objectifying and simplifying the increasingly complex financial transactions that have emerged from an ever-expanding investment in financial engineering. Equally significant is the need for a more informed understanding of the changes that have occurred in the influence structures in the world of accounting politics, both national and international, of the changing role that accounting plays in the informational environment of organizations, and how accounting changes in relation to shifts in the underlying nature of the socioeconomic system in which businesses operate.

Standardization is the process of developing and agreeing upon technical standards. The standard is a document that establishes uniform engineering or technical specifications, criteria, methods, processes, or practices. Some standards are mandatory while others are voluntary. Voluntary standards are available if one chooses to use them. Some are de facto standards, meaning a norm or requirement that has an informal but dominant status. Some standards are de jure, meaning formal legal requirements. Formal standards organizations such as the International Organization for Standardization or the American National Standards Institute are independent of the manufacturers of the goods for which they publish standards.

In social sciences, including economics, the idea of standardization is close to the solution for a coordination problem, a situation in which all parties can realize mutual gains, but only by making mutually consistent decisions. Standardization implies the elimination of alternatives in accounting for economic transactions and other events. Harmonization refers to reduction of alternatives while retaining a high degree of flexibility in accounting practices. It allows different countries to have different standards as long as the standards do not conflict. For example, within the European Union harmonization program, if appropriate disclosures are made, companies are permitted to use different measurement methods: for valuing assets, German companies could use historical cost, while Dutch businesses can use replacement costs without violating the harmonization requirements.

The purpose of using international accounting harmonization is that similar accounting transactions are treated the same by companies around the world, resulting in globally comparable financial statements. However, the consistent use of unified accounting information system by firms will show that they are changeable, because they depend on the varying economic, political, and cultural conditions in one state. Accountants, auditors, and information scientists around the globe are planning to harmonize accounting information systems with the goal of creating one set of high-quality accounting rules to be applied around the world.

With increasing globalization of the marketplace, international investors need access to financial information based on harmonized accounting systems and procedures. Investors constantly face economic choices that require a comparison of financial information. Without harmonization in the underlying methodology of financial reports, real economic differences cannot be separated from alternative accounting systems and procedures. Harmonization is used as a reconciliation of different points of view, which is more practical than uniformity and may impose one country's accounting point of view on all others. With the growth of international business transactions by private and public entities, the need to coordinate different investment decisions has increased. This would also lead to the reduction of the information diversity between managers and investors. This information diversity is costly and can be blamed for the decrease in managers' bonus, the increase of the equity's cost, and the inaccuracy of economic and the financial forecasts.

Historically, harmonization of international accounting information systems has tended to follow the integration of the markets served by the accounts. For example, the move to unified national accounting system in the United States in the early twentieth century followed the integration of the national economy. Similarly, the present impetus for a global accounting information system follows the accelerating integration of the world economy. Without a common accounting system, cross-border portfolio and direct investments may be distorted, the monitoring of management by shareholders obstructed, the contracting inhibited, and the cost of these activities needlessly inflated by complex translation (Meeks and Swann, 2009).

According to business practices it is obvious that the usage of harmonized international accounting systems leads to a reduction of the information asymmetry between the owners and the managers. This information asymmetry is leading to increasing costs of equities and less accurate economic and financial forecasts. This requires the development and review of national accounting rules, the separate validation of tax and accounting regulations, the repeal of the subordinate role of accounting, and the issuing of international standards with the help of practical and theoretical accounting experts.

As an example, for a multinational company like Daimler Chrysler, which owns more than 900 subsidiaries operating in more than 60 countries spread across 5 continents, the published financial results according to the international accounting system is 1.5 times of the one according to German accounting rules. If earning after taxation (EAT)—deducted actual tax burdens—according to US GAAP (generally accepted accounting principles) is taken as 100 percent, due to the differences in national accounting rules, EAT would be 25 percent more in the United Kingdom, 3 percent less in France, 23 percent less in Germany, and 34 percent less in Japan (Barth et al., 2007).

PREVIOUS RELATED LITERATURE: A REVIEW

International accounting literature provides evidence that accounting quality has economic consequences, such as costs of capital (Leuz and Verrecchia, 2000), efficiency of capital allocation (Bushman and Piotroski, 2006), and international capital mobility (Günther and Young, 2002).

Epstein (2009) compared characteristics of accounting amounts for companies that adopted IFRS (International Financial Reporting Standards) to a matched sample of companies that did not, and found that the former evidenced less earnings management, more timely loss recognition, and more value relevance of accounting amount than did the latter. This study found that IFRS adopters had a higher frequency of large negative net income and generally exhibited higher accounting quality in the post-adoption period than they did in the pre-adoption period. The results suggested an improvement in accounting quality associated with using IFRS.

Botsari and Meeks (2008) found that first-time mandatory adopters experience statistically significant increases in market liquidity and value after IFRS reporting becomes mandatory. The effects were found to range in magnitude from 3 to 6 percent for market liquidity and from 2 to 4 percent for company by market capitalization to the value of its assets by their replacement value.

Daske et al. (2007) also found that the capital market benefits were present only in countries with strict enforcement and in countries where the institutional environment provides strong incentives for transparent filings. In the order of the IFRS adoption countries, market liquidity and value remained largely unchanged in the year of the mandate. In addition, the effects of mandatory adoption were stronger in countries that had larger differences between national GAAP and IFRS, or without a preexisting convergence strategy toward IFRS reporting.

The increased transparency promised by IFRS could also cause a similar increase in the efficiency of contracting between firms and lenders. In particular, timelier loss recognition in the financial statements triggers debt covenants violations more quickly after firms experience economic losses that decrease the value of outstanding debt (Ball and Shivakumar, 2005; Ball and Lakshmann, 2005).

Accounting theory argues that financial reporting reduces information asymmetry by disclosing relevant and timely information, for example, Frankel and Li (2004). Because there is considerable variation in accounting quality and economic efficiency across countries, international accounting systems provide an interesting setting to examine the economic consequences of financial reporting. The European Union's (EU) movement to IFRS may provide new insights as firms from different legal and accounting systems adopt a single accounting standard at the same time. Improvement in the information environment following change to IFRS is contingent on at least two factors, however. First, improvement is based on the premise that change to IFRS constitutes change to a GAAP that induces higher quality financial reporting. For example, Ball et al. (2006a) found that the accounting system is a complementary component of the country's overall institutional system and it is also determined by firms' incentives for financial reporting. La Porta (1998) provides the first investigation results of the legal system's effect on a country's financial system. These results suggest that common law countries have better accounting systems and better protection of investors than code law ones.

Other factors associated with financial reporting quality include the tax system (Daske and Gebhardt, 2006), ownership structure (Jermakovicz et al., 2007; Burgstahler et al., 2006), political system (Li and Meeks, 2006), and capital's structure and capital market development (Ali et al., 2000). Therefore, controlling for these institutional and firm-level factors becomes an important task in the empirical research design. As a result of the interdependence between accounting standards and the country's institutional setting and firms' incentives, the economic consequences of changing accounting systems may vary across countries. Few papers have examined how these factors affect the economic consequences of changing accounting standards. For example, Pincus et al. (2006) found that accrual anomaly is more prevalent in common law countries. Maskus et al. (2005) found that accounting quality is associated with tax reporting incentives. Exploration of the interaction between these factors and the accounting information system can provide insights into differences in the economic consequences of changing accounting principles across countries.

Prior researches, for example, Meeks and Meeks (2002), have raised substantial doubt regarding whether a global accounting standard would result in comparable accounting around the world. But differences in accounting practices across countries can result in similar economic transactions being recorded differently. This lack comparability complicates cross-border financial analysis and investment. Some evidence of earning management (e.g., reducing of transition costs and information asymmetry, benefits of investors in investment strategy) can be found in the research done by Iatridis and Rouvolis (2010). They showed how firms that operate in a non-common-law countries (e.g., Greece), which are stakeholder-based, respond to international accounting standards adoption as compared to shareholder-based systems (e.g., United Kingdom).

No matter how similar the accounting systems in different countries, there will be slight or even bigger differences in the way they are applied by companies due to the differences in the economic, political, and cultural environments. Chatterjee (2006) demonstrated how cultural differences can affect accounting practices in countries characterized by small power distance and weak uncertainty avoidance accounting measures, which are more likely to be used as an indicator of a manager's performance than as a measure of the effectiveness of policies and procedures prescribed for them. Various researches draw the conclusion that countries having different cultures also have different accounting rules and practices.

2. Classification of Accounting Systems

This chapter presents the hypothetical classifications of international accounting system and shows the three main information systems in details: the European accounting system, the US GAAP, and international accounting standards. Here, "accounting system" will be used in terms of the financial reporting practices employed by a company for an annual report. The systems could be classified into groups by similarities and differences. If all or most of the enterprises in a country use very similar accounting practices, this might suggest that countries can be classified on the basis of accounting practices.

The classification of accounting systems will help to describe and compare international accounting systems in a way that will promote improved understanding of the complex realities of accounting practices. This classification should contribute to an improved understanding of:

- the extent to which national accounting systems are similar to or different from each other;
- the pattern of development of individual national systems with respect to each other and their potential for change;
- the reasons why some national systems have a dominant influence while others do not.

Classification will also help policymakers assess the prospects and problems of international harmonization. Developing countries seeking to choose an appropriate accounting system will also be better informed about the relevance for them of the systems used by other countries. The education of accountants and auditors who operate internationally would also be facilitated by an appropriate classification system.

Doupnik and Perera (2007) devised a hypothetical classification of accounting systems based on some explanatory variables to show the differences in measurement practices.

1. Classes
   - micro-fair-judgmental and commercially driven
   - macro-uniform government-driven and tax-dominated

2. Subclasses
   - business economics and extreme judgmental (The Netherlands),
   - business practice, professional rules, and British origin

3. Families
   - UK-influenced and professional-regulated (Australia, New Zealand, United Kingdom, Ireland)
   - US-influenced and enforcement by Securities and Exchange Commission (SEC; Canada, Israel, United States)
   - code-based and international-influenced (Italy)
   - plan-based (France, Belgium, Spain)
   - statue-based (Germany, Japan)
   - economic-controlled (Sweden)

All attempts were made to isolate those features of a country's financial reporting practices that may constitute long-run fundamental differences between countries. The result was a selection of nine factors:

1. Type of users of the published accounts of listed companies
2. Degree to which law or standards prescribe in detail and exclude judgment
3. Importance of tax rules in measurement
4. Conservatism/prudence (e.g., valuation of assets)
5. Strictness of application of historical cost (in the historical cost accounts)
6. Susceptibility to replacement cost adjustments in main or supplementary accounts
7. Consolidation practices
8. Ability to be generous with provisions (as opposed to reserves) and to smooth income
9. Uniformity between companies in application of rules

Connections:

1. Micro-fair-judgmental and commercially driven class covers two subclasses
   - business economics and extreme judgmental,
   - business practices, professional rules, and British origin
2. macro-uniform, government-driven, and tax-dominated class contains four families
   - code-based and international-influenced
   - plan-based
   - statue-based
   - economic-controlled

The micro-fair-judgmental and commercially drives class is also known as the Anglo-Saxon or Anglo-American model, used to describe the approach of the United Kingdom and the United States, where accounting is oriented toward the decision needs of large numbers of investors and creditors. This model is employed by most English-speaking countries and others heavily influenced by the United Kingdom or the United States.

The macro-uniform, government-driven, and tax-dominated class originated in the code law countries of continental Europe. It is also known as the Continental European model, and is used by most of Europe, Japan, and other code law countries. Companies in this group usually are tied quite closely to banks that serve as the primary suppliers of financing.

The inflation-adjusted model is found primarily in South America (Argentina, Brazil, Chile, and Mexico). This model distinguishes itself, however, though the extensive use of adjustments for inflation.

The UK-influenced countries follow former British colonial system on accounting development: Hong Kong, Malaysia, Nigeria, Philippines, South Africa, Singapore, Taiwan, Sri Lanka, Zambia, Botswana, Namibia, and Zimbabwe.

The macro-uniform countries and companies in the macro countries are more heavily influenced by taxation than are companies in the micro countries.

These factors were designed for developed countries that share certain economic features. If one wished to include developing countries, it would be necessary to include other discriminating factors, such as the degree of development of the economy or nature of economic systems.

Nobes (2006) showed the classification of some financial reporting systems. In this system "US GAAP" refers to the well-defined set of practices required by US regulators to be used by certain US companies. Users of this system are SEC-registered US companies and certain large Japanese companies for their group accounts. US GAAP bears a family resemblance to UK and International Financial Reporting Standard (IFRS) rules, and is in a class of systems suited to strong equity markets.

Strong equity class covers UK, Irish, Dutch individual, and US SEC-registered companies. Weak equity class covers Belgian, French, German, Italian, and Japanese enterprises.

Radebaugh and Gray (2007) presented the cultural classification of international accounting systems:

- Anglo-American culture area (United Stated, United Kingdom, and British colonials)
- Nordic countries (The Netherlands, Sweden, Finland, Denmark)
- Germanic accounting (Germany, Austria, Israel, Switzerland, and former European colonies in Africa)
- Latin group (France, Italy, Brazil, Argentina, Belgium, Portugal, Spain, Chile, Columbia, Mexico, Peru, and Uruguay)
- Asian accounting (China, Japan, India, Pakistan, Hong Kong, Singapore, Malaysia, and Philippines)

In the following chapters I will go over the three main international accounting systems in detail:

1. The European accounting system
2. The US GAAP,
3. International accounting standards (IAS)

EUROPEAN ACCOUNTING SYSTEM

The EU made efforts to harmonize the accounting standards of its member states through regulations, directives, official statements, and recommendations in 1970s and 1980s. The intention of a common regulation of accounting and financial reports comes from the Treaty of Rome (March 25, 1957), which has defined the four freedoms, namely, the free movement of goods, the free movement of capital, the free movement of persons, and the free movement of services. Accordingly, people are free to settle down and start new enterprises applying the national laws of the country of settlement. In order to meet the requirement of free movement of capital within the EU, it is necessary to ensure the transparency and accuracy of accounting data. The obligation of financial reporting (profit and loss account, balance sheet) and auditing helps the shareholders and stakeholders in decision-making, facilitating the defense of their interests independently from the seat of the company (freedom of settlement).

The common regulation of accounting in the EU is hierarchical. The basic rules are set down in company law. In the EU legislation system the law-making function of the state is strictly separated from the application of law. The regulations are written down and there is a priority of common law with respect to the national law.

Regulations

The regulations are obligatory and they come into force directly, without ratification of the member states. One of the most significant regulations of the European Parliament and Council of the European Union as far as accounting standards are concerned is the 1608/2002 of July 19, 2002. This regulation requires, for instance, that the companies registered on the stock market from 2005 onward are committed to submit the consolidated financial statements compiled according to the IAS and IFRS. It is the member states' right to decide on whether they oblige the companies operating in their country to use IAS and IFRS when compiling their financial statements.

Directives

The directives are defining legal frameworks of the EU, determining criteria and requirements to be met in national law; therefore, they seem to be long-term regulations. Directives referring to general accounting principles are as follows:

- *78/660/EEC* fourth directive about the financial statement of companies;
- *83/349/EEC* seventh directive about the consolidated financial statement;
- *86/635/EEC* eighth directive about the certification procedure of the operation of certified public accountants in charge of supervision and audit of the financial statements.

The directives contain the required minimum information of the financial statement, the compulsory structure of the profit and loss account and of the balance sheet, the criteria of evaluation of assets, the definition of the rules of submitting simplified financial statement, and the way of publication.

The accounting directives are aimed at ensuring accuracy and transparency, and accordingly providing reliable information on the financial situation of a company. The Council of the European Union in conjunction with the European Economic and Social Committee codified that the *78/660/EEC* directive is to be applied in every member state's national law within a certain period of time.

Directive No. 4

This directive aims at ensuring the accurate, transparent overview of the financial situation of companies for comparison between different member states' financial statements. The financial statements as a unit include the profit and loss account, the balance sheet account, and the notes to the financial statements in every member state. There are examples for application of simplified financial statements depending on the total value of assets, the revenues, and the number of employees (when at least two out of three is under the limit in consecutive years). It is common in member states that the criterion of accounting fixed assets is the usage of it for long-term purposes. The distinction of extraordinary income and expenditure from operating income and expenditure applying the accrual policy is also a common procedure in the European Union. Additional common traits are the depreciation policy, the obligation of audit report as an annex of the financial statement, and the publication and deposit of the financial statement.

Directive No. 7

A group of companies including the parent company and the affiliates operating in different countries are obliged to submit a consolidated financial statement. This directive ensures the financial comparability of such reports and makes it possible to show the group as a single corporation filtering the necessary transactions between the affiliates in order to present the accurate financial situation and performance of the group. In the member states the consolidated financial statement contains the consolidated profit and loss account, the consolidated balance sheet, and the consolidated notes to the financial statement. It is common to filter the liabilities and the receivables between the consolidated companies under "incomes" and "expenditures." The date of the affiliate's financial statement can coincide with the one of the parent company.

Directive No. 8

This directive intends to establish congruence between the different regulations regarding the requirements that have to be fulfilled by certified public accountants. It gives common guidelines for an auditor person and for an auditor company. The main elements of the directive are as follows:

- avoidance of incompatibility;
- adequate education and qualification requirements, including practice;
- certification is to be a separate process for every single qualified person, which guarantees equal criteria for the auditor candidates.

The member states have to ensure that the certified public accountant be fair, independent, and professionally updated.

Announcements

The official statements are not compulsory; they give guidelines for application of directives or complementary information on them such as *COM/2003/285* about the auditing or *XV/7009/97* concerning directives *78/660/EEC* and *83/349/EEC*, and also *XV/D3/7002/97* regarding the introduction of EUR. There are official statements explaining the accounting of profit or loss due to exchange rate when converting a foreign currency. The overall function of official statements is to clarify some definitions that have different interpretations in the member states.

Recommendations

The recommendations formulate solutions that are not obligatory, such as the recommendation in connection with the quality assurance of the auditing (*C/200/3004*) or about the independence of the certified public accountants (*C/2002/1873*). Furthermore, there is a recommendation for including environmental issues into the annual report.

Europe is rich in well-tested, highly advanced accounting and controlling concepts. However, each accounting tradition has thus far been developed and applied more or less in a specific national context. A huge potential to shape the accounting and controlling practice globally remains unused and unexploited. I therefore propose a cooperation initiative that addresses all European controlling and accounting associations, as far as possible with the support of the EU. Its mission is:

- to bring the major players in the controlling and accounting scene in Europe together for such a pan-European initiative;
- to establish one European standard for accounting and controlling by combining the strengths of different approaches;
- to take the lead in defining international accounting standards,
- to create enough alternatives to attract non-European parties to join the initiative; secondly the development of a new proven "best practice" in creating controlling, accounting, and analytical data to support managerial decision-making based on an international accounting performance concept is at best still in its early stage. What I completely lack so far is analytical and accounting concepts based on the international performance

philosophy supported by management in detailed day-to-day decision-making.

US GAAP

In the United States, generally accepted accounting principles, commonly abbreviated as US GAAP or simply GAAP, are accounting rules used to prepare, present, and report financial statements of a wide variety of entities, including publicly traded and privately held companies, nonprofit organizations, and governments. Commonly GAAP includes local applicable accounting framework, related accounting law, rules, and accounting standards.

Similar to many other countries practicing under the common law system, the US government does not directly set accounting standards, in the belief that the private sector has better knowledge and resources. Although US GAAP is not written in law, the US SEC requires that it be followed in financial reporting by publicly traded companies. Currently, the Financial Accounting Standards Board (FASB) is the highest authority in establishing generally accepted accounting principles for public and private companies, as well as for nonprofit entities. For local and state governments, GAAP is determined by the Governmental Accounting Standards Board (GASB), which operates under a set of assumptions, principles, and constraints different from those of standard private-sector GAAP. Financial reporting in federal government entities is regulated by the Federal Accounting Standards Advisory Board (FASAB).

House of GAAP

The term “House of GAAP” is commonly used to illustrate the hierarchy of pronouncements, standards, and similar literature that constitute US GAAP (table 2.1).

Table 2.1 **US GAAP categories**

Categories	**House of GAAP**		
Category (A) (most authoritative)	FASB standards and interpretations	APB opinions	Accounting Research Bulletins (ARBs)
Category (B)	FASB technical bulletins	AICPA Industry Audit and Accounting Guides	AICPA Statements of Position (SOPs)
Category (C)	FASB Emerging Issues Task Force (EITF)	AICPA AcSEC practice bulletins	
Category (D) (least authoritative)	AICPA accounting interpretations	FASB implementation guides (Q and A)	Widely recognized and prevalent industry practices

Source: Doupnik and Perera (2007).

Categories A and B are considered authoritative. Categories C and D are considered marginally authoritative thoughts on interesting and unique issues, but could be invalid given a large level of materialism. Categories C and D are considered a talking and reasoning phase of bringing issues to an authoritative level of GAAP.

Financial accounting is information that must be assembled and reported objectively. Third parties who must rely on such information have a right to be assured that the data are free from bias and inconsistency, whether deliberate or not. For this reason, financial accounting relies on certain standards or guides that are called "generally accepted accounting principles" (GAAP).

Principles derive from tradition, such as the concept of matching. In any report of financial statements (audit, compilation, review, etc.), the preparer/auditor must indicate to the reader whether or not the information contained within the statements complies with GAAP.

Principle of regularity: Regularity can be defined as conformity to enforced rules and laws.

Principle of consistency: This principle states that when a business has once fixed a method for the accounting treatment of an item, it will enter all similar items that follow in exactly the same way.

Principle of sincerity: According to this principle, the accounting unit should reflect in good faith the reality of the company's financial status.

Principle of the permanence of methods: This principle aims at allowing the coherence and comparison of the financial information published by a company.

Principle of noncompensation: One should show the full details of the financial information and not seek to compensate a debt with an asset, revenue with an expense, and so on.

Principle of prudence: This principle aims at showing the reality "as is": one should not try to make things look prettier than they are. Typically, revenue should be recorded only when it is *certain* and a provision should be entered for an expense, which is *probable*.

Principle of continuity: When stating financial information, one should assume that the business will not be interrupted. This principle mitigates the principle of prudence: assets do not have to be accounted at their disposable value, but can be accounted at their historical value.

Principle of periodicity: Each accounting entry should be allocated to a given period and split accordingly if it covers several periods. If a client prepays a subscription (or lease, etc.), the given revenue should be split to the entire time-span and not counted for entirely on the date of the transaction.

Principle of full disclosure/materiality: All information and values pertaining to the financial position of a business must be disclosed in the records.

Principle of utmost good faith: All information regarding a firm should conform to GAAP—this is defined as the standard guideline of accounting rules for financial accounting and to prepare financial statements for private companies and the companies trading publicly in the United States. It chalks down the standards, conventions, and rules to be followed by accountants while recording and summarizing transactions and in the preparation of financial statements. In the United States these rules are decided by the GASB, which applies to local and state governments.

The GAAP are not a rigid set of rules; they are merely flexible guidelines. Over the years, this set of conventions and standards has evolved due to the specific need for a common standard platform for the preparation and presentation of financial statements. In United States, the American Institute of Certified Public Accountants (AICPA), the FASB, and the SEC offer guidance and assistance about standard acceptable practices of accounting.

Acquiescence with GAAP promotes creditability with stockholders and creditors reassuring them and outsiders that the financial report of a company precisely reflects its financial position.

Routine auditing is done by certified public accountants to determine the compliance of financial statements with GAAP. Financial statements display these audit findings. Even finance companies, banks, and investors look for these audited financial statements of their clients.

The principles of GAAP is based on four fundamental qualities the financial statements must possess. The financial statements must be relevant, reliable, consistent, and comparable. Economic entity assumption, going concern assumption, monetary unit assumption, and periodic reporting assumption are the four basic assumptions used for financial statements.

GAAP applies four basic principles to implement and achieve the objectives.

1. Historical cost principle—Companies should consider the acquisition costs and not fair market value for their liabilities and assets
2. Revenue recognition principle—Accrual basis accounting is preferred
3. Matching principle—This principle allows greater evaluation of actual profitability and performance as the expenses are matched with the revenues
4. Principle of full disclosure—Information disclosed in the financial statement should be enough to make a judgment while keeping the costs reasonable

United States Securities and Exchange Commission (SEC)—During the Great Depression, the SEC was created in response to a need for a structure setting accounting standards. The SEC works closely with various private organizations setting GAAP, in the belief that the private sector has the proper knowledge, resources, and talents, but does not set GAAP itself.

American Institute of Certified Public Accountants (AICPA)—The SEC urged the AICPA and in 1939, the Committee on Accounting Procedure (CAP) came into existence. However, it could not address the growing need for a structured body of accounting principles. So, in 1959, the AICPA created the Accounting Principles Board (APB), which was also dissolved in 1973 for lack of productivity and failure to act promptly. So, finally, the AICPA created the FASB.

Financial Accounting Standards Board (FASB)—Realizing the need to reform the APB, the new structure was composed of three organizations: the Financial Accounting Foundation (FAF), the Financial Accounting Standards Advisory Council (FASAC), and the major operating organization—the FASB.

Governmental Accounting Standards Board (GASB)—With structure similar to that of the FASB, the GASB was created in 1984 to address state and local government reporting issues.

The FASB publishes the following four major types of publications:

1. Statements of Financial Accounting Standards—the most authoritative GAAP setting publication. More than 150 such publications have been issued to date.
2. Statements of Financial Accounting Concepts—first issued in 1978. They are part of the FASB's framework project and identified and established fundamental concepts and goals guiding the FASB in the development of future standards. However, they are not a part of GAAP. There have been seven concepts published till date.
3. Interpretations—This publication is focused toward the modification or extension of existing standards. There have been around 50 interpretations published till date.
4. Technical Bulletins—These are basically guidelines on applying standards, its interpretations, and opinions. They usually solve some very specific accounting issue that will not have an important and long-lasting effect.

The Accounting Standards Executive Committee (AcSEC) established by AICPA publishes the following:

1. Audit and accounting guidelines, which concludes the accounting practices for specific industries such as

colleges, airlines, and casinos. It offers specific guidance on issues that are not addressed by the FASB or GASB.
2. Statements of position, which offers guidelines on topics related to financial reporting until they are addressed by the FASB or GASB.
3. Practice bulletins, which reflect the views of AcSEC on narrow financial reporting issues.

The legal system in North America countries and the United Kingdom is based on common and statue laws. Common law goes along with statue law; they coexist in the regulation. The company law in the United States contains rules at the national level and also at local and state levels.

The three basic forms of enterprises are:

1. Sole proprietorship
2. Partnership
3. Corporation

The principles created by generalization of common law, the guides, and the informants are all part of the US regulation system in practice. In the United States, accounting regulations are made and issued by professional organizations, whereas in the European system the state has the power of legislation.

The stock exchange–listed companies are strictly regulated by SEC, mostly not regarding book-keeping or posting items to general/subledger (except for some cases), but rather in terms of financial statement, based on adequate audit process, formal and structural requirements of income statement, balance sheet, and the additional complementary information to be released. The US financial statements are specific for being consolidated. The balance sheet contains data for two comparative terms, whereas the income statement and the cash flow has for three. As an annex, the changes and the range of stockholders' equity value in comparative term has to be released as well. As the US GAAP does not regulate the substructure of the main items of the financial statements, SEC created special rules for stock exchange–listed companies.

In a narrower sense US GAAP means: regulations made by AICPA. Being so, the FASB is in charge of issuing the financial accounting standards. Therefore, US GAAP is the set of standards and explanations, modifications, bulletins, and statements issued by the FASB. However in a wider sense, opinions, releases, bulletins, statements, guides, interpretations, and implementations of other organizations can also be included in its definition.

The US GAAP, being a very detailed description of regulation in the United States, is a model based on the rules. All the three big sources of accounting regulations are valid and can be applied in certain areas (stock exchange, affiliate company regulation) which can sometimes cause complicated additional theoretical and practical tasks within a company.

In the United States, as a consequence of violations of law and accounting regulations, there are initiatives meant to introduce stricter rules and promote willingness among private sector and state administration to control certified public accountants' services. The current regulation in the United States does not guarantee anymore that the investors on stock exchange trust in them. The ideas for corrections tend to restrict the range of services the certified public accountants can provide and they are likely to underline the importance of applying a quality management system, which can help rebuild the confidence of shareholders and stakeholders.

The financial statement consists of:

- Balance sheet
- Income statement
- Cash flow
- Statement of owners' or stockholders' equity as follows:
  - Statement of retained earnings
  - Comprehensive income statement
  - Notes disclosures
  - Other financial reports, for example, complementary tables, letters to director, informants, data supplied to state administration, management summaries, forecasts, releases, and environmental studies

Balance Sheet

In the balance sheet the assets and liabilities are listed according to their liquidity. The stockholder's equity comes from the difference between all assets and all liabilities.

The current assets are generally listed as follows:

- liquid assets
- negotiable securities
- accounts receivable
- inventories
- deferred charges
- other current assets

Within accounts receivable:

- trading accounts receivable
- accounts receivable affiliated company
- other receivables

The trading accounts receivable and the other receivables are detailed in separated lines, showing their historical cost (value) and their recorded loss. The balance sheet helps financial analysts to judge the financial flexibility (solvency and liquidity) of an economic entity periodically in a certain monetary unit also using the main principles, which are as follows:

- understandability
- relevance
- reliability
- comparability
- consistency

When evaluating the balance sheet items, contrary to the Hungarian method, the American terminology does not apply the "preparation date of balance sheet" as an evaluation date. In the US GAAP there is no regulation for evaluating assets on market value at "preparation date of balance sheet."

The events after balance sheet date are handled by US GAAP as follows: the facts known at balance sheet date are separated from facts that occurred afterward. It takes into consideration the influencing facts known at balance sheet date by modifying the value of assets (e.g., loss of accounts receivable). Accordingly, until the issue date of the balance sheet all influencing factors, known at balance sheet date, are included in the financial statement. If the market value of an item (e.g., risk of an account receivable) by balance sheet date is known at the time of preparing the balance sheet, it must be recorded in the books and included in the balance sheet.

The events occurring after balance sheet date are the so-called value modifying facts, but they are not recorded in the books. Being so, if a customer pays at a different foreign exchange rate from the one effective at balance sheet date (value recorded in balance sheet), the value of the accounts receivable is not modified in the books. The profit or loss realized by security trading as well as the effect of a disaster, if it occurred in the period of preparation of the balance sheet, has to be left out when preparing the statements. However in order to meet the requirement of reliable overall picture, it is to be included in the complementary notes.

Regulators prefer to contract balance sheet items/lines that have no information value to help the financial statement to be as informative as possible. Due to this important facts influencing the financial situation of a company will not be missed and will guarantee the correct flow of information to stakeholders and financial analysts.

The equality of balance sheet is determined as follows:

Assets (A) = Liabilities (L) + Stockholders' equity
(capital, C).

In financial accounting terminology "capital" equals stockholders' equities; however, in legal parlance in the United States it means face value of the shares issued.

The correspondence between current assets and short-term liabilities is insured by several classifications (detailed further on) that are aimed at defending the working capital of the company. Many US GAAP deal with defining like short-term liabilities. The main principle is the linkage to current assets, which can last one year or if more, be linked to a production cycle. The linkage to current assets means that short-term liabilities can be paid from current assets or if they are paid any other way, another short-term liability occurs instead of them.

In certain states of the United States no dividend can be paid if the working capital does not cover the amount. Long-term loans are duet immediately in some cases, when the working capital decreases below a certain level.

The liquid assets in US GAAP include cash, money in bank accounts, and cash equivalent securities. It is for financing liabilities for any purpose in a year or if longer in a production cycle, for example, coin, bank note, bank deposits, current accounts, payment orders, checks, and fixed deposits. The maximum three-month duration securities belong to this category as well, for example certificate of deposit, draft. A negative bank account balance means short-term liabilities, bank overdraft. However, all bank accounts have to be taken into consideration while summarizing the balance to decide if it is a liquid asset or a short-term liability in the balance sheet.

When evaluating debt securities, the face value and the nominal rate are the determining factors besides the market rate. If the nominal rate differs from the market rate (market rate is higher) the issue of the security is not profitable at face value. If nominal rate < market rate, discount rate is applied; if nominal rate > market rate, premium rate is applied as buying rate. The premium rate means the surplus of value that could become an additional interest during investment year when the compound interest would increase its value as an alternative investment possibility.

This is the price for which it is worthy to offer the security for sale.

The securities that are intended to be kept until maturity remain assets of the enterprise. These can be current assets if there is less than one year left until the maturity date. If the enterprise is not sure about how long it intends to keep the securities, they cannot be recorded on this line.

Trading securities are accounted as a loss of creditor's risk, without booking discount or premium rates. The interest is included in the local price; it is not taken out from the book value.

Regarding debt securities:

- less than 20 percent share (trading or other),
- 20 percent or from 20 percent to 50 percent shares,
- 50 percent or above shares.

The trading securities are to be recorded as current assets and they are to be sold. The so-called not realized profit/loss is recorded in books. These securities are recorded at historical value, which contains the buying price and the collateral costs as well. The evaluation is at market value, the nonrealized profit/loss is recorded in income statement. The profit or loss is realized when the securities are sold. Regarding these securities no premium or discount rate is accounted, the change of creditor's risk is accounted as a loss. The interest is included in the price, it is not taken out from the book value.

Trade receivables are accounts receivable deriving from product and service sales, which can be an open promise or a written promise (drafts), the latter meaning paying fixed amounts in the future (trade bill) or financing (finance bill). The receivables should be through the principle of measurement grouped and connected to an activity cycle such as realized, realizable, earned receivables.

Other receivables include advance payment, short-term deposit, short-term asset handover with guarantee, receivable interest, receivable dividend, recompenses, inventory allowances, rebated for prompt payment.

The inventories' cost price cannot include either the cost of sales or other collateral costs, or the interest on purchase of inventory. Inventories can be evaluated as follows: single cost price, weighted average price, rolling average price, FIFO method.

Intangible assets are grouped according to the extent to which it is possible to determine them: easy to determine (patents, concessions, royalties, franchise contracts, software, leasing contracts) and not easy to determine (goodwill).

Long-term liabilities are evaluated according to the time value. If the interest rate on the liability does not equal the market rate, the face value of the liability has to be modified by the difference adequate to the risk. The difference (discount or premium) is to be booked as a liability.

The leasing transactions have two mainly different types: operative leasing and financial leasing. The latter means that the leased object gets into the property of the lessee, therefore it bears all the connected risks of it. The object is capitalized and at the same time it is a liability in books. Each installment is divided in capital portion and interest portion. On the contrary, the amount of lease charges are divided in equal portions (linear) in duration period and are accounted as a cost in case of operative leasing.

Deferred tax accounting is a category in financial statement that handles the timing difference regarding taxes, and accordingly the effect on rate-able value, tax liabilities/tax returns accounting. The deferred tax liability/asset derives from the timing difference of the tax deduction statement dates and balance sheet date. The deferred tax liabilities/assets balance determine if the deferred tax expenditure or the deferred tax revenue is accounted for in the financial statement. The aim is to filter the temporary elements (modifications) of tax deductions (due to timing differences) and show the net balance of tax liabilities and assets. The deferred tax asset means a future return of tax-payable, and the deferred tax liability means a future payable tax.

Evaluation of Balance Sheet Items

Historical cost accounting means that the original value, the exchange rate effective on recording date, is registered in books. Every single movement is to be evaluated at original and also current exchange rate. Accordingly the cumulated sum of them gives the balance by balance sheet date. The exchange rate at balance sheet date means the official exchange rate of the chosen bank.

The historical cost of assets is modified in the financial statement, and the market value is used. This so-called current cost accounting method focuses on the change of value instead of the effect of general inflation. Current cost accounting takes in consideration the assets' price changes by evaluating every single asset. Due to the cumulated profit or loss in evaluation after movement of assets and change of exchange rates, there is a so-called not realized profit or loss and as a balance of it, a realized profit or loss, which is booked and posted to sub/general ledger.

In order to be able to evaluate the balance sheet items, two groups have to be made:

1. Monetary assets, which are special for registering them on a spot price—according to US GAAP, their book value is the original, nominal value modified by discount rate or by premium. However at balance sheet date they are evaluated at current market value.
2. Nonmonetary assets are booked at historical cost. This historical cost is modified in financial statements when evaluating on market price at balance sheet date. The increase of the value of these assets is not booked. Current cost accounting modifies the accounting of these assets to market price in the balance sheet as in the income statement.

In case of high inflation effect, the price of an asset keeps changing day by day. However, these value changes have nothing to do with the deterioration or market of the asset. In accounting these assets are devaluated because of the financial market trends and changes of price indexes. The financial source of supplement at historical value of an asset should be the depreciation. For example, two years from now, an asset that has a value of 100 units today can be supplemented, supposing an inflation rate of 20 percent, for 144 units (1.2 × 1.2 × 100) ignoring other price effects on the asset's market. The 44-unit difference occurs in addition to the accounting books, which can be covered by the income increase due to inflation rate, but the state levies tax on that, and the earnings after tax go as a dividend to the shareholders. Therefore nothing can guarantee that the enterprise can produce the source of supplement.

Beside historical cost accounting the US GAAP has many other areas where the base of evaluation is the market value. The market value supposing a developed financial and capital market could become a reference price of securities' evaluation. The future cash flow as well as in case of security evaluation could be the base of the value of an asset. In order to satisfy the information needs of investors and creditors, accounting methodology's evaluation shall be convertible to current value. There are several methods for calculating time value of money (e.g., earnings based market value calculation).

Income Statement

The income statement helps financial analysts to judge the efficiency of the companies in the past, to prepare forecasts for the future, and to estimate the risk of future cash flow. The risk is not only because of the uncertain nature of the future. There are several factors that can influence the profit, especially the following:

- The so-called not-realized profit/loss dependent on future events cannot be registered in books.
- Different accounting methods (e.g., depreciation) can have different results even if other income statement items are the same.
- The profit/loss is sometimes a result of management decisions (evaluation policy).
- So-called *creative accounting*. The pressure to reach high share list leads to the wish to optimize the cash flow, showing high earnings. This is in fact a manipulation aimed at increasing income or hiding expenditures. In the latter case the target is to increase the present expenditures (overestimating the reserve found, or the loss of credit). The financial markets where the confidence is essential can collapse if such things happen.

The forms of income statements are different, depending on the categories used:

- Single-step statement: Revenues – Expenditures = Net Income
- Multistep statement: It distinguishes between business and nonbusiness income
- Business profit/loss = Revenues – Costs (Costs can be calculated by natural expense classification or by functional expense classification)
- Nonbusiness gains and losses
- Extraordinary profit/loss after tax (extraordinary events coming from physical, economic environment, influencing income)
- Profit/loss due to changes of accounting policy, after tax
- Earnings per share (EPS)

Another specialty is the intraperiod tax allocation, which means that tax is allocated to business profit/loss, to stopped activity profit/loss, to extraordinary profit/loss,, and to profit/loss due to changes of accounting policy. The main items in income statement can be detailed according to the company's wish.

In accordance with SEC requirements, the regulation for income statement is to separate the revenues according to activities but the categories should not represent more than 10 percent of the total revenue. In case of splitting categories (exceeding the 10 percent), the expenditures should be separated accordingly.

The profit/loss for stopped activities has to be separated from other outcome in order to be able to compare the amounts until a decision is made.

The extraordinary profit/loss is not connected with business. It is caused by significant events, which are: unusual, low likelihood; and in-estimable events, their recurrence cannot be calculated. Mainly the environmental risks of the company can be listed here.

The not extraordinary profit/loss is as follows: amortization or reversal of assets; outcomes of transactions made in foreign currency; profit/loss of stopped activity; expenses caused by strike (payable to customers or to competitors).

The obligatory complementary notes contains detailed information on significant market segments for the company, adjusting the structure of income statement to them.

Cash Flow Statement

It shows the cash movements (in and out from the company) and the financial situation of the company.

The main parts of this statement are as follows:

1. Operating activities' cash flow

2. Investing activities' cash flow
3. Financing activities' cash flow

The Text Part of the Annual Report

The financial reporting system of US GAAP consists of two main parts: financial statement and other financial reports.

The FASB opinion in accordance with the investors' requirements says that it is important to include every information that has a significant effect on the company's field of activity (full disclosure principle) taking into consideration the cost-benefit principle as well. It means that it is not necessary to provide an information if the cost of it is higher than its benefit (benefit that can be gained from that information).

Notes Disclosures

- Relevant facts of accounting policy are to be included (e.g., balance sheet date)
- Evaluation process of inventories, other evaluation methods
- Investment mirror (increase, decrease, classification changes detailed in items)
- Liabilities detailed in due date, interest rate according to items
- Shareholders' equity
- Relevant accounting estimations
- Deferred taxes
- Important events between balance sheet date and issue date

Audit Report

This statement aims at providing official, professional, and independent opinion (prepared according to the US GAAP) by the certified public accountant (CPA) about the enterprise in terms of the reliability of the data and information included in the financial statement, ensuring that the contents and the overall picture are fairly stated.

The CPA audit is necessary if:

- shareholders of the company need it and therefore they decide in favor of it;
- creditors insist on it; and
- enterprises are regulated by law on securities.

Management's Discussion and Analysis

It is an individual chapter in the annual report, where the management assesses the liquidity, the financing policy, the composition of capital, and the earnings from operations. Moreover, the pleasant or unpleasant tendencies, the company's position in the market, the economic environment, and the effect of increase/decrease of prices can also be detailed in this part.

Management's Letter to Shareholders

The controlling system should have an important role in the operation of companies, which needs to identify the environmental changes that caused deviation from original aims, tasks, and requirements. The controlling helps the management in decision preparation, in finding the surplus in operations, avoiding anomalies or harmful consequences.

The management is responsible for reliability of information in the annual report and complementary notes. The annual report is to be done according to US GAAP and other generally accepted accounting principles. The annual report is audited by a certified public accountant who has access to any financial data source, even the minutes of the board of directors. The management runs the controlling system in order to be sure about the reliability of reports and to be able to defend the company's assets from unauthorized use. The system is regulated by rules and policies that guarantee personal and professional fairness.

Other Specialities of US GAAP

The pressure to reach high share list leads to the wish to optimize the cash flow, showing high earnings. This is in fact an intention, a planned manipulation aimed at increasing income or hiding expenditures or applying deferred accounting. This intention is not necessarily a fraud. However the financial markets where confidence is essential can face the threat of collapse if such things happen. In the United States the enterprises are free to decide on the structure of their income statement and balance sheet. In order to meet the profitability requirement of managers (driven by premium expectations) and shareholders (expecting dividend), every method and process aim at satisfying it so that the information needs form the accounting system. The creative accounting includes the so-called window dressing manipulations that can be disclosed by controlling, but also the techniques that are very complicated to discover even for a professional or for a certified public accountant.

Manipulations that can be disclosed by a control are:

- asset sales,
- asset evaluation tricks,
- reconstruction and reparation of assets (intentional distortion),
- intentional mistakes in booking,
- ongoing adjusting of the accounting policy in order to get some advantages through it,
- current assets booked as fixed asset (or vice versa),

- leaving in books assets with high value that cannot bring benefit (brake of prudence rule), and
- distortion of asset historical cost (book value), intentional false estimation for lifetime of asset.

According to the FASB, if the world needs the capital market of the United States, it can be required that the enterprises entering the market apply US GAAP regulations when preparing their financial statements. This position based on power can be accepted if one looks at the NASDAQ (New York Stock Exchange), which is only one of several stock exchanges in New York where 2,800 companies' shares are listed, of which capitalization equals more than 15,000 million USD. The foreign companies take 465 of it with a market value of 5 million USD. The European FTSE (stock exchange in London) and DAX (stock exchange in Frankfurt) all together do not reach half of the capitalization of NASDAQ.

The generally accepted accounting principles were developed by AICPA in 1920s. Later, it became the task of the FASB (Financial Accounting of Standard Board; which was not a state institute but a professional organization) from 1959 and 1973. The taxes do not influence the US GAAP, which causes the obligatory admission of the deferred taxes to the list of assets and liabilities. The deferred tax can be calculated in two ways:

- in the temporary, in time-equivalent tax per increasing and decreasing item of rateable value,
- in the evaluation of assets and liabilities (modifications in value), having consequences on income and through income, and on income tax as well.

If the depreciation, the loss of accounts receivable, is more than can be put as decreasing item of rateable value into the tax return, the amount of income tax on surplus (to be recalled) is deferred charge on asset side.

If as a consequence of inventory evaluation a profit occurs, in US GAAP balance sheet the income tax on that profit (calculated according to law on income tax) as a deferred tax is booked on the liabilities side. So the deferred tax as future charges is a receivable in the balance sheet and decreasing the income tax payable in the income statement, while the deferred tax as accrued charges is a liability in the balance sheet and increasing the income tax payable in the income statement. The different temporary and evaluation caused effects on earnings are to be summarized and after calculating the tax effect of them, the balance is to be booked in asset side or in the liability side. The deferred taxes are obligatory to be accounted in the balance sheet.

The application of US GAAP was ordered by SEC in 1933 based on the law of securities; therefore, formally, the US GAAP is obligatory only for those companies listed on the stock exchange. In the United States the consolidated financial statement formally and in contents does not differ from a single (nonconsolidated) one. There is no special obligation for consolidation; the regulations are the same. However as far as a mother company is concerned, the significance of the consolidated financial statement is much bigger than its own single financial statement as a separate legal entity.

The single consolidated financial statement is not obligatory to prepare and release; the possibility of paying dividend is derived from the consolidated cumulated profit as source of financing. When consolidating in the United States the vesting interest determines the structure, and therefore the minority shareholders are part of "foreign capital." The earnings they can get is booked as an expenditure; the earnings after tax in the income statement are the earnings of the majority shareholders. The minority shareholders' shares are on a separate line after earnings after tax. The pure profit is the earnings after tax minus the minority shareholders' shares.

INTERNATIONAL ACCOUNTING STANDARDS

International accounting standards (IAS) are accounting principles, rules, and methods ("standards") issued by the International Accounting Standards Board (IASB), an independent organization based in London, United Kingdom. They purport to be a set of standards that ideally would apply equally to financial reporting by public companies worldwide. Between 1973 and 2000, international standards were issued by IASB's predecessor organization, the International Accounting Standards Committee (IASC), a body established in 1973 by the professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom and Ireland, and the United States. During that period, the IASC's principles were described as "International Accounting Standards" or IAS. Since April 2001, this rule-making function has been taken over by a newly reconstituted IASB. From this time on the IASB describes its rules under the new label "IFRS," though it continues to recognize (accept as legitimate) the prior rules (IAS) issued by the old standard-setter (IASC). The IASB is better-funded, better-staffed, and more independent than its predecessor, the IASC. Nevertheless, there has been substantial continuity across time in its viewpoint and in its accounting standards.

Widespread international adoption of IFRS offers equity investors the next potential advantages by Ball et al. (2006b):

1. IFRS promises more accurate, comprehensive, and timely financial statement information relative to the national

standards they replace for public financial reporting in most of the countries adopting them, Continental Europe included.

2. Small investors are less likely than investment professionals to be able to anticipate financial statement information from other sources. Improving financial reporting quality allows them to compete better with professionals, and hence reduces the risk they are trading with a better-informed professional.
3. IFRS eliminates many of the adjustments analysts historically have made in order to make companies' financials more comparable internationally.
4. The reducing of the cost of processing financial information most likely increases the efficiency that the stock market incorporates it in prices.
5. IFRS offers increased comparability and hence reduced information costs and information risk to investors.

With increasing globalization of the marketplace, international investors need access to financial information based on harmonized accounting standards and procedures. Investors constantly face economic choices that require a comparison of financial information. Without harmonization in the underlying methodology of financial reports, real economic differences cannot be separated from alternative accounting standards and procedures. Standardization is used as a reconciliation of different points of view; this is more practical than uniformity, which may impose one country's accounting point of view on all others. Organizations, private or public, need information to coordinate its various investments in different sectors of the economy. With the growth of international business transactions by private and public entities, the need to coordinate different investment decisions has increased. A suitable accounting information system can help multinational enterprises accomplish their managerial functions on a global basis. Further, standardization of the manner in which reports are prepared can greatly enhance the value of accounting systems to their users and increase transparency to investors and regulators.

In countries whose culture is characterized as small power distance and weak uncertainty avoidance, one would expect a greater tendency to use accounting measures as an indicator of the results of the manager's decisions. Thus, the profit of a profit center is more likely to be used as a measure of manager performance than to indicate the effectiveness of policies and procedures prescribed for the manager. Likewise, cost is more likely to serve as an indicator for the results of decisions made by a cost center manager.

For example, in the United States and Taiwan it was found that managers in many Taiwanese firms did not have the full range of general management skills because the boss virtually took all of the decisions. Taiwan's strong uncertainty-avoidance and long-term orientation are consistent with this tendency toward centralization.

Germany's strong uncertainty-avoidance culture also suggests a tendency toward centralization. Evidence of such a tendency is provided by an automobile industry expert. "Of the top 100 managers—at Volkswagen, 50 are not used to making their own decisions or thinking on their own" (Lere, 2009).

There is a significant body of evidence that identifiable differences in the dominant culture of countries do exist and that they are associated with differences in the typical accounting practices of countries.

There are divergent views on how comparability should be achieved. Some believe that comparability is best achieved by limiting the application of judgment and selection among possible choices. Others believe that comparability may be achieved through disclosure of the judgments that were made and how they impact the financial results. The more comparability is mandated, the more rules will be required to enforce it. Striving to obtain complete comparability, under detailed rules-based regimes, often defeats the purpose because the real comparability is lost through the many bright lines and exceptions created by the rules themselves.

Business management requires that resource consumption be measured, rated, assigned, and communicated between appropriate parties. Managers of businesses use accounting information to set goals for their organizations, to evaluate their progress toward those goals, and to take corrective action if necessary. Decisions based on accounting information may include which building and equipment to purchase, how much merchandise inventory to keep on hand, how much cash to borrow, and so on. Modern accounting renders its services to a wide variety of users: investors, government agencies, the public, and management of enterprises, to mention but a few. Many accountants work in business firms as managerial accountants, internal auditors, income tax specialists, systems experts, controllers, management consultants, financial vice presidents, and chief executives.

Accounting is, therefore, a service to management, a special-purpose tool that must be used but not misused. Like any special-purpose tool, if it is neglected or not used it will surely go rusty and fail to provide the good service for which it was designed. However, all tools have their limitations and it is well to point out at this early stage some fundamental limitations inherent in any system of accounting.

INTERNATIONAL ACCOUNTING ORGANIZATIONS

The International Accounting Standards Committee was founded in 1973 for the purpose of developing the International Accounting Standards. Organizations from Australia, Canada, France, Germany, Ireland, Japan, Mexico, The Netherlands, the United Kingdom and the United States were represented among its founders.

The objectives of IASC are as follows:

- to develop a single set of high-quality, understandable, and enforceable accounting standards that require high-quality, transparent, and comparable information in financial statements to help participants in the world's capital markets and other users make economic decisions,
- to promote the use and rigorous application of those standards, and
- to promote the harmonization of national accounting standards and regulations and International Accounting Standards.

Initially the IASC issued standards in connection with the accounting treatment and interpretation of major issues. Within these standards, the IASC accepted multiple solutions and methodologies concerning accounting treatment and measurement. The purpose of subsequent amendments was to narrow the scope of alternative solutions permitted by the standards. This became necessary partly due to a notice issued by the International Organization of Securities Comissions (IOSCO). The IOSCO made it clear that standards would only be acceptable if they eliminate alternatives, and if they are comprehensive but, at the same time, sufficiently detailed. The IASC established the Standing Interpretations Committee (SIC) in 1997 to integrate and facilitate the interpretation of the standards.

In 2001, IASC was transformed and the newly created body was named IASB. The objective of the IASB is to promote standards developed using the accounting practices of individual countries. The IASB seeks to promote its own standards as the official accounting regulations in developing countries where accounting laws have not yet been developed. The board considers its primary responsibility to be the harmonization of IAS standards with national and US GAAP standards..

In March 2001, the trustees approved and enacted the new constitution and the IASC Foundation, a not-for-profit organization, was founded.

A review of the constitution began in 2008. The first result of this process was the International Accounting Standards Committee Forum's (IASCF) new constitution, which has been effective since February 1, 2009. The changes included the foundation of a monitoring board and the expansion of the IASB from 14 to 16 members.

A nominating committee was set up in 1999 that would select a body of 19 trustees, and the composition of the body was laid down in the new IASC constitution. Accordingly, six of the trustees must be selected from North America, six from Europe, four from the Asia/Pacific region, and three from any other region.

The key responsibilities of the trustees include:

- developing the operating structure of the various organizational units,
- appointing the members of the board,
- appointing the members of the SIC,

- appointing the members of the Standards Advisory Council (SAC), and
- overseeing the activities of the IASC.

The trustees appoint the 14 members of the board, including 12 full-time and 2 part-time members. The main responsibilities of the board include:

- approving the publication of discussion drafts,
- approving the final versions of IASs and SICs,
- setting up steering committees, and
- preparing and developing draft standards.

The Standards Interpretations Committee is responsible for interpreting standards and providing guidance if the relevant areas are not specifically addressed by a standard or the framework, or if existing standards are not properly applied.

The SAC is a public forum (typically meeting three times a year) for those involved in the preparation of financial statements.

The main purpose of the monitoring board is to establish a framework for cooperation between the IASC Foundation and capital market authorities to facilitate the application of IFRSs and the harmonization of IFRS rules with capital market regulations and requirements.

Furthermore, the responsibilities of the monitoring board also include the approval of the appointment of trustees, as well as the oversight and support of the trustees' work.

The monitoring board is made up of the competent leaders of the European Commission, the Japanese Financial Services Agency, the US SEC, the IOSCO's Emerging Markets Committee, and the IOSCO's Technical Committee. The chairman of the Basel Committee on Banking Supervision is involved in the work of the monitoring board as an observer.

The IASC Foundation is responsible for appointing the twenty-two trustees based on their professional and geographical backgrounds. Currently, six of the trustees working for the foundation are from North America, six from Europe, four from the Asia/Oceania region, and four from any other region. Their responsibilities include oversight of the operation, ensuring financing, and appointing the members of the IASB, the SAC, and the International Financial Reporting Interpretations Committee (IFRIC).

The purpose of the IASB is to promote standards developed using the accounting practices of individual countries and facilitate their application. It is responsible for compiling the technical agenda and the approval of standards, exposure drafts, and interpretations.

According to the IASCF constitution, it currently consists of sixteen members, no more than three of whom may be part-time. Members are selected based on their professional and geographical backgrounds: four from the Asia/Oceania region, four from Europe, four from North America, one from Africa, and one from South Africa, as well as two from any other region.

The designation of standards was also changed to allow the standards issued by the IASB and the IASC to be distinguished. The standards of the IASC are called international accounting standards, while the IASB's standards are designated as International Financial Reporting Standards or IFRSs. IFRSs have been created as part of a process aimed at convergence with US GAAP standards.

The adoption of the standards was facilitated by the interpretations issued by the SIC. This body was replaced in 2002 by the IFRIC, which is involved in developing interpretations of IFRSs.

In April 2008, the Financial Stability Forum (FSF) published a report ("Report on Enhancing Market and Institutional Resilience") through the cooperation of leading international organizations and financial institutions. The report contains 67 recommendations, 3 of which relate specifically to the area of financial reporting:

1. Off-balance sheet entities: according to the recommendation, the IASB should improve the accounting and disclosure rules for off-balance sheet vehicles working toward international convergence in accounting.
2. Fair value in illiquid markets: the IASB should develop a more robust guidance on the measurement of financial instruments, with special regard to cases when the market of the financial instrument is no longer active.
3. Disclosures: the IASB should develop standards to include more precise and comprehensive disclosures in financial statements with respect to measurements, methodologies, and uncertainties associated with measurements.

To address the financial reporting issues and problems arising from the global financial crisis, the IASB and the US FASB jointly set up a high-level advisory group (the Financial Crisis Advisory Group, FCAG).

The recommendations formulated by the FSF had been included in the IASB's work plan prior to the report; however, with a view to the global financial crisis, the IASB assigned priority to the following areas:

- Fair value measurement, especially for financial instruments
- Review of the criteria for consolidation, with special regard to special purpose entities (SPEs) and structured investment vehicles

- Amendment of the rules on the derecognition of financial instruments, which is carried out as part of a joint project with the FASB
- Comprehensive revision of IAS 39 Financial Instruments: recognition and measurement
- Amendments to IFRS 7 Financial Instruments: disclosures
- Complete convergence of accounting standards by the target year of 2011

In October 2008, the IASB issued Amendments to IAS 39 Financial Instruments: recognition and measurement; and IFRS 7 Financial Instruments: disclosures. Main changes include amendments to the reclassification rules for financial instruments: in special circumstances, or if the entity's intention or ability to hold the financial instruments changes, then reclassification is permitted for some financial instruments (IAS 39.50 and 50B to 50F). Amendments to IFRS 7 are consequential amendments arising from amendments to the reclassification rules for financial instruments (IFRS 7.12 and 7.12A).

The European Union endorsed the amendments to IAS 39 and IFRS 7 (Commission Regulation No 1004/2008) and requested a review of the application of these standards. The main focus of the review was the issue of the fair value measurement of financial instruments in the case of inactive markets. As a result, the IASB issued a guidance in October 2008 on the fair value measurement of financial instruments in inactive markets; this guidance requires the use of internal models.

The IASB and FASB have been discussing the aforementioned topics regularly, and proposed amendments and drafts have been issued. Focus areas for 2009 included the treatment and measurement of financial instruments, the accounting treatment of credit losses, as well as the review of the model of incurred and expected losses.

HUNGARIAN ACCOUNTING SYSTEM

Hungary has had more than one hundred years of experience in domestic accounting. A first attempt to define and compile the value of national income and national wealth in Hungary was made in 1855. The next important step in the development of domestic accounting in Hungary was the compilation of national accounts for the period of 1920–30. The new period of national accounting started in 1950. In accordance with a general reorganization of the state apparatus and the introduction of Soviet-type central planning, the theoretical basis of the new, official national accounts was the Marxian concept of "productive work" accounting according to which only the production of material goods creates original income, a theory going back before Marx to Adam Smith and Ricardo.

In Hungary, accounting requirements are regulated by law from 1991. The Ministry of Finance is responsible for accounting and auditing regulation. For the operation of the market economy it is essential that objective information based on past data be available on the financial and earnings position of undertakings, nonprofit organizations, and other types of economic organizations, as well as on the development thereof, in order for the participants on the market to be able to make well-founded decisions based on the information made accessible.

Hungarian Act of Accounting contains accounting rules that are in harmony with the relevant directives of the European communities and with international accounting principles. It is based on reliable information providing an authentic and true overall picture with respect to the income-producing capability, the development of the assets, the financial situation, and future plans.

The financial government is authorized to decree:

1. The reporting and book-keeping obligations of budgetary organizations, the special turnover-related definitions used for their annual accounts, and book-keeping in line with the provisions laid down in the Act on the State Budget.
2. The special regulations concerning the annual accounts and book-keeping obligations of the National Bank of Hungary, of credit institutions, financial firms, insurance companies, the stock exchange, clearing houses, and other similar bodies providing clearing or settlement services, investment funds, and other funds, following consultation with the National Bank of Hungary.

These regulations concern the activities and the requirements of the body designated to maintain the register of providers of accounting services, the procedure for admission into and removal from the register, the detailed regulations for keeping the register, compulsory professional training, and the legal remedies available.

The Act on Accounting includes very detailed accounting requirements based on the Fourth and Seventh EU Company Law Directives and IFRS. From 2005 on these standards apply only to the legal entity financial statements of companies and to the consolidated financial statements of nonstock exchange–listed companies that do not opt to present financial statements prepared in accordance with IFRS.

Hungarian annual report shall give a true and fair view of the financial and earnings position of the undertaking, as well as of any changes therein. It shall contain all assets, equity, reserves, and liabilities (considering all accrued and deferred items as well), and all revenues and expenditures during the period in question, the after-tax profit and the balance sheet profit or loss figure, and the data and explanation necessary to give a true and fair view of the actual financial situation of the undertaking, as well as the results of its operation.

The type of the annual report is specified in accordance with the amount of annual net sales revenues, the balance sheet total, the number of employees, and the limits thereof.

The following types of annual reports shall be applied:

1. Annual report
2. Simplified annual report
3. Consolidated annual report
4. Simplified report

With the exception laid down companies shall maintain double-entry book-keeping, based on which their annual report is prepared.

Companies are allowed to file simplified reports—supported by single-entry book-keeping—if permitted under the government decrees referred to.

Undertakings keeping double-entry books are subject to annual reporting and shall prepare business reports.

Companies keeping double-entry books may prepare a simplified annual report if, on the balance sheet date in two consecutive years, two of the following three size-related indices do not exceed the following limits:

1. the balance sheet total does not exceed 500 million forints;
2. the annual net sales revenues do not exceed 1,000 million forints;

3. the average number of employees in the year under review does not exceed 50 persons.

The annual report is composed of the balance sheet, the profit and loss account, and the notes on the accounts. A business report shall also be prepared concurrently with the annual report. The comparability of the annual reports of consecutive financial years shall be provided for by the structure, division, and contents of the balance sheet and the profit and loss account, as well as by the constancy of the valuation principles and procedures of balance sheet items. Valuation of balance sheet items shall be based on the principle of going concern, unless the enforcement of this principle is hindered by a provision to the contrary, or any factor or circumstance prevails, which contradicts the continuation of entrepreneurial activities.

The valuation principles applied in the preparation of the balance sheet for the previous year may be changed only if the factors causing the change prevail on a permanent basis, that is, for no less than a period of one year, and the change consequently qualifies as permanent or long term. In this case, the factors causing the change, and the effect thereof expressed in numbers, shall be detailed in the notes on the accounts. The profit and loss account shall contain a detailed account of the undertaking's balance sheet profit or loss figure, that is, the after-tax profit retained by the undertaking (with the effect of any major errors on the balance sheet profit or loss figure of (the) previous financial year(s) shown separately), the main factors of import concerning the development or modification of profits or losses, as well as the components and development of the profit or loss for the financial year defined by adding up the income from operations and the income from financial transactions (the two jointly referred to as "profit or loss of ordinary activities") and the extraordinary income (income before taxes), less tax liabilities (jointly referred to as "profit after taxes"), increased by the profit reserve used for dividends, profit-sharing, and yields on interest-bearing securities, and reduced by the dividends, profit-sharing, and yields on interest-bearing securities paid (payable).

Income from operations can be established in two different ways, depending on the undertaking's decision:

1. As the difference between net sales revenues accounted for in the financial year, the value of own work shown as assets, other income and the total amount of material costs accounted for in the financial year, staff costs, depreciation, other operating charges (total costs method)
2. As the difference between net sales revenues accounted for in the financial year and the difference between the direct and indirect cost of sales, and the difference between other income and other operating charges (turnover costs method)

The notes on the accounts shall include all numerical data and explanatory information prescribed by this act, as well as the figures in addition to those contained in the balance sheet and in the profit and loss account, which are necessary for the true and fair demonstration of the undertaking's financial and earnings position, and the results of its operation for the owners, investors, and creditors. The notes on the accounts shall also contain information—as prescribed by other legal regulations—on any unique or special activities.

In the notes on the accounts the undertaking's financial and earnings position shall be assessed for the purposes of a true and fair view, along with the composition of assets and liabilities, the relation between the equity and liabilities (creditors), and the trends in liquidity, solvency, and profitability.

The constituent parts of the accounting policy, any change thereof, and the consequence of any change on the profit or loss figure shall be separately illustrated in the notes on the accounts.

The notes on the accounts shall illustrate the guiding principles applied in the course of compiling the annual account and their main characteristics, the valuation procedures and the method of accounting for depreciation as defined in the accounting policy and the frequency with which it is used, explanations for any difference influencing the profit or loss arising from procedures departing from those applied in the previous year and applied in respect of the individual balance sheet items, as well as the effect thereof on the financial and earnings position, and on the profit or loss.

The consequence of any major errors discovered by audit on the profit and loss, as well as on the assets and liabilities, which is combined in the balance sheet and the profit and loss account, shall be shown in the notes on the accounts broken down on a yearly basis.

The purpose of the business report is to demonstrate the financial and earnings position, the course of business of the company—including the key risk factors and uncertainties imminent in the company's activities—through evaluating the figures contained in the annual report in a manner that provides a true and fair view, reflecting the actual circumstances on the basis of facts from the past and of estimated future data.

The business report shall contain an exhaustive analysis of the company's performance and any improvement in business trends, consistent with the company's size and structure.

The following shall be described in the business report:

- any significant events and particularly important developments that took place following the balance sheet date;
- planned development (in line with the development of the business environment, known or expected, and with the proposed impact of internal policies);
- the area of research and experimental development;
- the business premises;
- the company's employment policy.

In the course of assessing whether the obligation of preparing a consolidated annual report applies, the following entitlements (rights) shall be disregarded:

- those that are exercised for others, based on a contract, in the capacity of transferee;
- those that have been received as collateral, and the rights are exercised in accordance with the instructions of a third party;
- those that have been transferred to its possession as guarantor, and the rights are exercised in the interest of guarantee.

The parent company need not prepare a consolidated annual report on the financial year if on the balance sheet date in two consecutive years preceding the financial year, two of the three indices listed here do not exceed the following limits:

1. the balance sheet total does not exceed HUF 2,700 million,
2. annual net sales revenues do not exceed HUF 4,000 million,

3. the average number of employees in the financial year does not exceed 250 persons.

The consolidated annual report shall consist of the consolidated balance sheet, the consolidated profit and loss account, and the consolidated notes on the accounts.

The consolidated annual report shall be prepared in a clear and concise manner in due observation of the accounting principles, and in such a way that it gives a true and fair view of the financial and earnings position of all companies included in the consolidation.

If the figures contained in the consolidated balance sheet and profit and loss account are not sufficient for providing a true and reliable overall view, or if so justified by special circumstances, the consolidated notes on the accounts shall contain all figures necessary for the true and fair demonstration of the financial and earnings position, as well as the results of the operation of the companies included in the consolidation.

Valuation and consolidation methods employed in the preparation of the consolidated annual report for the previous financial year, or the division and breakdown of the report may only be changed in justified cases. Any deviation from the previous financial year shall be listed and justified in the consolidated notes on the accounts, and the effect thereof on the financial and earnings position shall be explained.

If the balance sheet date of the annual report of a company included in consolidation precedes the balance sheet date of the consolidated annual report by more than three months, then such company shall draw up an interim annual report by the balance sheet date of the consolidated annual report, and it shall be included in the consolidation based thereon. The subsidiary company and joint undertaking, which has operated as a precompany and is registered before the balance sheet date of the consolidated annual report, shall also be included on the basis of an interim annual report. The period to which the interim annual report pertains may not exceed 12 months.

If a consolidated subsidiary company is transformed during the financial year to which the consolidated annual report pertains, whereby it is required to prepare a final annual report by the date when the transformation is completed, then such undertaking shall be included in consolidation based on the interim annual report that contains the data of the predecessor subsidiary company or joint undertaking as well.

In the case of merger, the statutory interim annual report applies if the merged company was deemed a subsidiary company or a joint undertaking prior to the merger.

In the course of the preparation of the consolidated annual report, the annual balance sheets and profit and loss accounts of the parent company and the subsidiaries included in the consolidation shall be summarized.

The assets and liabilities and the revenues and expenditures of the subsidiary companies included in consolidation shall be included in the consolidated annual report in full, while the assets and liabilities and the revenues and expenditures of joint undertakings included on the basis of capital share shall be included in the consolidation in the percentage of the capital share, regardless of whether or not the companies included in the consolidation have taken such into consideration in their annual reports, provided that the parent company is not limited by this act in inclusion, or the parent company has no option to decide or choose. In the course of preparing the consolidated annual report, the parent company may exercise the option in presenting the balance sheet, and the options to decide and choose provided in this act even if the companies included in the consolidation have not exercised them, or is not obliged to exercise them in spite of them having been exercised by the companies included in the consolidation in their annual reports.

The consolidated business report shall contain the situation and the course of business of the entire group of companies included in the consolidation—including the key risk factors and uncertainties imminent in the company's activities—in a manner that provides a true and fair view reflecting the actual circumstances.

A company keeping double-entry books and registered in the company register shall deposit with the court of registry the annual report or simplified annual report approved by the body entitled thereunto and, in the case of a compulsory audit of the books, also containing the audit certificate or qualified audit certificate from the auditor, as well as the decision on the appropriation of the after-tax profit within 150 days from balance sheet date of the financial year in question. The annual report or simplified annual report deposited shall be of the same form and content (text) as the one examined by the auditor.

A parent company shall deposit with the court of registry its consolidated annual report approved by the body entitled thereunto, together with the audit certificate or qualified audit certificate from the auditor, within 180 days from the balance sheet date of the consolidated annual report. The consolidated annual report deposited shall be of the same form and content (text) as the one examined by the auditor.

The data contained in the annual report—simplified annual report, simplified report, consolidated annual report deposited with the court of registry, and, in the case of a compulsory audit, the auditor's report containing the audit certificate or qualified audit certificate from the auditor—shall be made available to the public; any person may receive information and may make copies thereof at the court of registry.

Hungarian branch offices of foreign-registered companies shall deposit with the court of registry the annual report approved by the foreign-registered company, together with the auditor's report containing the audit certificate or qualified audit certificate from the auditor, as well as the decision on the appropriation of after-tax profits within 150 days from the balance sheet date of the financial year in question. All companies keeping double-entry books (including the Hungarian branch offices of foreign-registered companies) shall publish their annual report or simplified annual report and, in the case of a compulsory audit of books, also the auditor's report containing the audit certificate or qualified audit certificate from the auditor, simultaneously upon depositing them. Publication of whole or a part of the notes on the accounts may be omitted if, in the view of the auditor in charge of the audit of the annual report or simplified annual report, the figures contained in the balance sheet and in the profit and loss account are sufficient for a clear assessment of the true financial and earnings position of the undertaking.

Companies shall be required to ensure that their employees and members have access to the company's annual report, the simplified annual report, and the consolidated annual report and, in the case of a compulsory audit of books, also the auditor's report containing the audit certificate or qualified audit certificate from the auditor, at the registered office of the company (parent company) and the right to make copies of all or parts of these reports.

If the annual report or simplified annual report of the undertaking was not audited, or, in the case of a compulsory audit, the auditor has refused its seal of approval, the undertaking shall place the following text on all copies of the balance sheet, profit and loss account, and notes on the accounts of the annual report or simplified annual report—"The data published have not been reviewed by an auditor." In such cases, publication of the notes on the accounts may not be omitted.

The parent company shall publish its consolidated annual report together with the auditor's report containing the audit certificate or qualified audit certificate from the auditor simultaneously upon depositing them.

When the annual report or simplified annual report already published, which relate to financial year preceding the financial year under review, contains major errors in relation to true and fair view, it will have to be republished. The annual report and simplified annual report when republished shall indicate the findings of the audit concerning

1. the closing data of the balance sheet of the financial year preceding publication and the corrected figures of assets and liabilities combined;
2. the data in the profit and loss account of the financial year preceding publication as pertains to the column of the subject year and the corrected figures related the previous year(s) as approved by the body authorized thereunto.

Deposit with the court of registry (with regard to companies registered in the register of companies) is required for the republication of an annual report or simplified annual report in the case of a compulsory audit, the auditor's report containing the audit certificate or qualified audit certificate from the auditor, and presentation to the body authorized for approval, furthermore, within 30 days of such approval.

Companies and Hungarian branch offices of foreign-registered companies shall be considered to have fulfilled the obligation of publication (or republication) once they have—simultaneously upon deposit—forwarded an original or a certified copy of the annual report, simplified annual report, and, in the case of a compulsory audit of books, together with the auditor's report containing the audit certificate or qualified audit certificate from the auditor, in the case of parent companies, the consolidated annual report to the Company Registration and Information Service of the Ministry of Justice.

The purpose of an audit is to ascertain that the annual report, simplified annual report, or consolidated annual report of an undertaking has been drawn up in accordance with the provisions of this act and, accordingly, to provide a true and fair view of the financial and earnings position and of the operations of the undertaking (and that of the undertakings included in the consolidation). The audit shall also investigate whether there is agreement between the annual report, the consolidated annual report, and the associated business report.

The auditing of books shall not be compulsory for undertakings whose annual net sales (calculated for the period of one year) do not exceed 300 million HUF on the average of the two financial year preceding the financial year under review.

The responsibility of the auditor independent of the company is to control the authenticity and regularity of the annual report, simplified annual report (the balance sheet, profit and loss account, and the notes on the accounts), as well as compliance with the provisions of this act and the deed of foundation, and, based on its findings, to form an opinion in summary of such findings concerning the annual report or simplified annual report, and to draw up the independent audit report.

The auditor of a consolidated annual report shall cooperate with the auditor of the undertakings included in the consolidation so that the figures of the annual reports consolidated into the consolidated annual report meet the requirements prescribed for consolidated annual reports, and the companies included in the consolidation take into consideration the rules applying to them in regard to the preparation of the consolidated annual report. This shall not, however, limit the responsibility of the auditor of the consolidated annual report.

The auditor of an undertaking included in the consolidation must cooperate with the auditor of the consolidated annual report so that the consolidated annual report gives a true and fair view of the joint financial and earnings position of the undertakings included in the consolidation.

The auditor shall prepare a written report on the audit of the annual report, simplified annual report, or the consolidated annual report, which is to contain the auditor's seal of approval or qualified audit certificate, and shall deliver the report to the commissioning undertaking.

The independent auditor's report must include the following:

1. The title of the addressee of the independent audit report.
2. The key data of the reviewed annual report, simplified annual report, or consolidated annual report (in particular, the name of the company to whom and the financial to which the given account pertains, along with the balance sheet date and the key characteristics

for the financial year), including an indication of the reporting system used in the process of drawing up the report.

3. Description of the scope of audit and an indication of the audit standards used in the course of the audit.
4. The method of auditing employed based on which the audit certificate or qualified audit certificate from the auditor is attached, also supported by a summary report.
5. The auditor's expressed opinion and/or conclusive remark stated in its audit certificate or qualified audit certificate in connection with the annual report, simplified annual report, or consolidated annual report attached in its seal of approval, or qualified audit report as to whether the report is in compliance with this act and with the provisions of other legal regulations that govern the duties of the auditor concerning the data and information provided in the report.
6. Reference to any issue to which the auditor expressly wishes to draw attention, without stating any opinion on the matter (explicit remark).
7. The auditor's opinion as to whether or not the annual report or consolidated annual report is consistent with the business report drawn up for the same year.
8. Date of the audit report.
9. The name, signature, address, and chamber registration number of the auditor who is responsible for auditing the accounts.
10. In respect of auditing firm's name and signature of the firm's authorized representative, name and address and chamber registration number of the firm.

If the notes on the accounts of the undertaking (or the parent company in the notes on the accounts of the consolidated annual report) contain no valuation, or if the valuation provided is false, the auditor shall demonstrate its facts and findings in the written report, describing the previous year, any major events, and, especially, any detrimental changes that have taken place following the balance sheet date of the annual report, simplified annual report, or consolidated annual report, and some unfavorable factors affecting the profit or loss for the year.

The minister of finance shall set up a National Accounting Committee composed of experts for the development of accounting theory and its methodological application, as well as in order to facilitate the practical enforcement of the basic accounting principles defined in this act.

The minister of finance is empowered to appoint and dismiss the chairman and members of the committee. He also appoints at least two-thirds of the committee members by recommendation from the appropriate trade association.

The Hungarian Accounting Standards Board has recently been established to take over the responsibility for setting Hungarian Accounting Standards (HAS) from the Ministry of Finance. The board was established by Government Decree 2002 of 2003 under the authority of the Accounting Act. Its establishment reflects the desire of the Ministry of Finance for accounting standards to be developed by the accounting and auditing professions rather than by government.

The HAS, according to a 2004 World Bank assessment of accounting and auditing practices in Hungary, differ from the International Financial Reporting Standards, despite significant efforts at harmonization. Being a European Union member, Hungary complies with the European Commission (EC) Regulation No. 1606/2002, which requires the application of IFRSs in the preparation of consolidated financial statements of listed companies. The 2008 EC report on the implementation of Regulation No. 1606/2002 points out that Hungary permits application of IFRSs in consolidated accounts of all entities within the scope of the Act on Accounting, but not in the annual accounts. The use of IFRSs in the annual accounts is allowed for informal purposes only. In this regard, the 2004 World Bank assessment recommended adoption of IFRSs for all public interest entities in the country.

In June 2009, the World Bank conducted a review of accounting and auditing practices in Hungary in order to evaluate the weaknesses and strengths of the accounting and auditing requirements and to compare the reporting requirements with actual practices. International Financial Reporting Standards, formerly IAS, and International Standards on Auditing (ISAs) were used as the benchmarks for assessing national standards. The Report on the Observance of Standards and Codes (ROSC) was published the same year, summarizing the results of the assessment and suggesting a reform agenda. The report noted that the Hungarian accounting framework is governed by the Act on Accounting, which is based on the EU fourth and seventh directives on the harmonization of accounting standards. The Act on Accounting lays down the HAS and is supplemented by government decrees based on special requirements for banks, insurance companies, stockbrokers, investment funds, pension funds, and various nonprofit institutions. As detailed in the ROSC, in addition to the Accounting Act, financial statements of banks must comply with Government Decree No. 250/2000 on Special Provisions Regarding the Annual Reporting and Bookkeeping Obligations of Credit Institutions and Financial Enterprises. For insurance companies, the Accounting Act is supplemented by the Government Decree No. 192/2000 on Reporting and Bookkeeping Requirements of Insurers. According to the description of the regulatory framework provided in the 2005 Chamber of Hungarian Auditors' (MKVK) self-assessment, the securities market, banks, and insurance companies are regulated by the Hungarian Financial Supervisory Authority (PSZAF). All listed companies, banks, and insurance companies are required to prepare and publish quarterly financial statements, which are reviewed by the PSZAF. Sanctions for noncompliance include delisting from the stock exchange. With regard to banks and insurance companies, the PSZAF can also perform an onsite inspection when irregularities are observed. Further action can include the recall of the auditor and management. In addition to quarterly reporting, banks are also required to tender an overall supervisory report every two years.

Act on Accountancy is promulgating the Europe Agreement establishing an association between the Republic of Hungary and the European Communities and their member states. Signed on December 16, 1991, in Brussels, this act contains regulations that may be fully approximated with the following legal regulations of the European Communities:

1. Fourth Council Directive of July 28, 1978, on the annual accounts of certain types of companies (*78/660/EEC*)
2. Seventh Council Directive of June 13, 1983, on consolidated accounts (*83/349/EEC*)
3. Directive *2001/65/EC* of the European Parliament and of the Council of September 27, 2001, amending Directives *78/660/EEC*, *83/349/EEC*, and *86/635/EEC* as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions

4. Regulation No. 1606/2002/EC of the European Parliament and of the Council of July 19, 2002, on the application of international accounting standards
5. Eleventh Council Directive *89/666/EEC* of December 21, 1989, concerning disclosure requirements in respect of branches opened in a member state by certain types of companies governed by the law of another state.

The detailed regulations, methods, and procedures implemented to supplement the legal provisions that are necessary for the principle of true and fair view shall be prescribed in national accounting standards. These national accounting standards shall not contradict the objectives and principles of this act, nor the process of harmonization of legal systems defined in Act I of 1994 promulgating the Europe Agreement establishing an association between the Republic of Hungary and the European Communities and their member states, signed in Brussels.

3. The Influencing Factors of Accounting Harmonization

After the summarizing and measuring of international accounting classifications and clusters it is important to show the possibility and reality of the information systems to harmonization and which factors promote and restrain the harmonization process in the world.

In order to harmonize the different kind of financial statements, the International Accounting Standards Board is working toward creating accounting principles that can be used worldwide (Epstein and Mirza, 2007). Although the objective seems easy, the execution might be problematic due to the diversity of the current principles. Accounting harmonization establishes a system where the financial statements are standardized and therefore they are transparent. However, it does not mean that the use of standards would result in an operating-consistent accounting system, because there are other factors that influence the harmonization process, for instance, the national legislation system and the regulations by auditors or by the courts.

The reason for differences in accounting principles between nations could be that they vary in the level of economic development, in the legal system, in the taxation system, in the intensity of capital market and so in the level of inflation, in the typical methods of financing an enterprise, in the shareholder background, and finally in political and cultural traits. All these factors determine the regulatory aims and philosophy behind the respective accounting principles.

LEGAL SYSTEM

Primarily, the legal system of a country influences its accounting principles. There are two main clusters: the "civil law system," based on codification (typical in almost all European countries except for the United Kingdom and in Japan), and the so-called common law system, which is precedent based (typical in the United Kingdom and in the United States). According to certain researches (e.g., Radebaugh and Gray, 2002) the principles of the financial reporting system and the accounting standards (especially regarding the principle of being careful or the discrete evaluation) differ very much from each other.

In the "civil law system" the accounting standards are laid down in laws by the elected deputies. It is not common for companies in these countries (continental Europe and the historical colonies of Belgium, France, Germany, Italy, Portugal, and Spain) to be registered on the stock exchange, and therefore the publication of financial statements is not a priority.

This system derives from the Roman Law (jus civile) the first description of which was the Codex Justinianeus in 529. The codification is done in accounting regulation as well (e.g., the Hungarian Law of Accounting 100/2000); however, the company law contains the most important rules for the operation of a company such as the publication of the financial statement and its formal requirements. In such countries the accountant professionals motivate the introduction of the international accounting standards. In the "common law system" only the frameworks are determined in the company law and the special regulation is done by the independent committee of accounting. Doing so, the committee focuses on the experience-based solutions elaborating in details the accounting rules for profit-oriented and nonprofit-oriented companies.

In the "civil law system" the Accounting Law is rather general, it does not contain special regulations; therefore, if the companies face special problems, they ask for help of auditors or search for other laws, for example, tax laws.

The "common law system" develops much more detailed regulation. For the special cases common general rules are applied (in the United States, Canada, Australia, or New Zealand). These countries are very market oriented and the investors trust much more in financial statements than in other states. The publication of this information is crucial. The regulation is clear and much more supportive of the information needs of the shareholders, of stakeholders, and of analysts. This is the best environment for international accounting standards.

FINANCING METHODS

The legal forms of companies and proprietors are different. In Germany, France, and Italy, the banks give the financial background. However in the United Kingdom or in the United States, the companies are financed mainly by shareholders. Generally speaking, in the latter countries the capital markets are quite strong and there is a sounder defense of the shareholders. The company structure could be influenced by the political interests as well.

It is worthwhile to analyze the proprietors and the financing companies in the EU. In Germany it is common to find banks owning shares of national companies and financing them at the same time. There are several national public limited companies in which Deutsche Bank owns a significant portion of shares. The situation is similar in France and Italy where the banks take part in decision-making and in the execution of these decisions due to the significant amount of shares they own. In the United Kingdom and the United States the main proprietors of national companies are the institutions rather than private shareholders. In the continental EU countries there are not many foreign shareholders; so for them it is not crucial to regulate the prompt publication of the financial statements as there is no need for as much audit and the tax laws overwrite the accounting requirements. On the contrary the private financing systems induce the need for adequate accounting information; therefore the accounting rules different from taxation regulations and they are not in a hierarchical context. There is a strong need for more auditors.

TAXATION SYSTEM

In France and Germany the taxation laws function as accounting rules too. For example, in Germany the tax account (Steuerbilanz) equals the accounting accounts (Handelsbilanz). Belgium, Italy, and Japan apply similar principles and the taxation laws have strong influence on the financial statements. In the United States and the United Kingdom the accounting regulation totally differs from taxation regulations and they handle it by deferrals, calculating the difference between the tax payable according to accounting regulation and taxation regulation. This also applies to Holland. There are examples also in Hungary for deferrals of tax payable when it is about consolidation.

INFLATION

The effect of inflation can be measured in connection with the evaluation of assets or when calculating the profit. The historical accounting principle of evaluation can cause problems in periods when there is a high inflation rate. The main problems arise when a multinational company wants to make a consolidation in countries where there is a high inflation rate. The effects of inflation can be seen when evaluating the fixed assets or most directly when converting foreign currency. Measuring profitability can be done in the currency of the parent company or of the affiliate company. For instance, if there is an acquisition, the accounting of the goodwill is a crucial issue. According to the US GAAP after goodwill no amortization can be accounted; they calculate it through the net present value of the capability of producing income.

4. Problems Caused by Accounting Diversity

PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

The diversity in accounting practice across countries causes problems that can be quite serious for some parties. One problem relates to the preparation of consolidated financial statements by companies with foreign operations. Consider General Motors Corporation, which has subsidiaries in more than 50 countries around the world. Each subsidiary incorporated in the country in which it is located is required to prepare financial statements in accordance with local regulations. These regulations usually require companies to keep books in local currency using local accounting principles. Thus, General Motors de Mexico prepares financial statements in Mexican pesos using Mexican accounting rules and General Motors Japan Ltd. prepares financial statements in Japanese yen using Japanese standards. To prepare a consolidated financial statement in US dollars, the parent company must convert the financial statements into US dollars and also convert the financial statements of its foreign operations into US GAAP. Each foreign operation must either maintain two sets of books prepared in accordance with both local and US GAAP or, as is more common, in the reconciliations case, considerable effort

J. Beke, *International Accounting Harmonization*

and cost are involved in company personnel developing the expertise to convert the accounting rules of one country to that of another.

A lack of comparability of financial statements can have an adverse effect on corporations when making foreign acquisition decisions. There was a very good reason why accounting in the communist countries of Eastern Europe and the Soviet Union was so much different from accounting in capitalist countries. Financial statements were not prepared for the benefit of investors and creditors to be used in making investment and lending decisions. Instead, financial statements were prepared to provide the government with information to determine whether or not the central economic plan was being fulfilled. Financial statements prepared for central planning purposes have limited value in making investment decisions.

THE UNIVERSAL INFORMATION METHODS' ROLE IN PERFORMANCE ASSESSMENT

Financial statements, called "accounting statements" in Hungary, reflect the results or the liability of management to enable making decisions such as whether investing instruments should be maintained or sold, or the assignment of management should be prolonged or replaced. Usually the total amount and availability of cash and cash equivalents are also requested and assessed since it determines the ability to fulfill obligations (transferring for suppliers, interests, and paying out dividend for shareholders). Users of financial statements could even better assess the total amount of cash and cash equivalents if the statement focuses on the financial situation or the performance of the business. The financial situation of a given economic entity is determined by the economic resources it possesses, the financial structure of the entity, its liquidity, and ability to adopt environmental changes. Preceding data on economic resources in possession and its changes in the past may be useful to create cash and cash-equivalent forecasts while preceding data on financial structure could be used for set-up loan forecasts and to determine how future revenues will be divided among shareholders. Analyzing accounting information may also be useful in determining how successful the business will be in acquiring additional finances. Forecast based on former rate of liquidity and dispensability may indicate whether or not the entity will be able to fulfill its due obligations. Data on the performance of business, especially on its profit, are required to forecast the future changes of economic resources that the business is likely to possess; thus data on changes of performance are relevant. From financial forecasts and trend extrapolations the following conclusions may be drawn: whether or not the given business could raise cash flow on the basis of existing resources; and how successfully it could use additional financial resources. The ability of a business to raise cash and cash equivalents and cash flow may be derived from all these data. Several sources of funds could be determined while creating forecasts of the financial situation of a given business, such as financial resources, working capital, liquid or financial instruments. Information on financial situation is primarily indicated in balance sheets while information on performance is indicated in profit and loss statements. Some components of financial statements are connected to each other since they are derived from the same transactions or event. Despite the fact that all of the statements provide different information, presumably none of them serves only a single purpose or contains answers to all requested questions. Profit and loss statement, statement of cash flow together with a balance sheet could provide an overview of an economic entity's performance.

ACCESS TO FOREIGN CAPITAL MARKETS

A second problem caused by accounting diversity relates to companies gaining access to foreign capital markets. If a company desires to obtain capital by selling stock or borrowing money in a foreign country, it might be required to present a set of financial statements prepared in accordance with the accounting standards in the country in which the capital is being obtained. Consider the case of the Swedish appliance manufacturer AB Electrolux. The equity market in Sweden is so small (there are fewer than nine million Swedes) and Electrolux's capital needs are so great that the company has found it necessary to have its common shares listed on stock exchanges in London and on the NASDAQ in the United States, in addition to its home exchange in Stockholm. To have stock traded in the United States, foreign companies must either prepare financial statements using US accounting standards or provide a reconciliation of local GAAP net income and stockholders' equity to US GAAP. This can be quite costly. In preparation for a New York Stock Exchange (NYSE) listing in 2008, the German automaker Daimler-Benz estimated it spent 120 million USD to initially prepare US GAAP financial statements; it expected to spend 30–40 million USD each year thereafter.

LACK OF HIGH-QUALITY ACCOUNTING INFORMATION

A fourth problem associated with accounting diversity is the lack of high-quality accounting standards in some parts of the world. There is general agreement that the failure of many banks in the East Asian financial crisis of 1997 was due to three factors:

1. A highly leveraged corporate sector
2. The private sector's reliance on foreign currency debt
3. Lack of accounting transparency

International investors and creditors were unable to adequately assess risk because financial statements did not reflect the extent of risk exposure due to the following disclosure deficiencies:

- The actual magnitude of debt was hidden by undisclosed related-party transactions and off-balance-sheet financing
- High levels of exposure to foreign exchange risk were not evident.
- Information on the extent to which investments and loans were made in highly speculative assets was not available.
- Contingent liabilities for guaranteeing loans, often foreign currency loans, were not reported.
- Appropriate disclosures regarding loan loss provisions were not made.

5. Economic Factors of Accounting Harmonization

International accounting harmonization has four important key economic aspects, such as division of labor, financial innovation, and capital and transaction costs.

ROLE OF INTERNATIONAL ACCOUNTING HARMONIZATION IN THE DIVISION OF LABOR

Even the work of Adam Smith (1776) concerning division of work demonstrates the significant change that leads from economic entities managed by their owners through divided leadership from shareholder till hired management. Hired management of limited partnership may provide further options for maximizing risk management and financing such projects that exceed those available for economic entities managed by their owners. In addition monitoring fund assessment and investment may be challenging without hired experts. Informational asymmetry may occur concerning asset valuation, namely, external shareholders are usually less informed of financial investments than hired managers also, which may cause motivational anxiety. As Adam Smith has written, "Management of such partnerships rather handles shareholders' investments than its own thus the same caution could not be expected that lead to lavishing of funds."

Let us now examine the role of international accounting standards in division of labor, but first of all in the absence of its adaptation let us consider the study of Gwilliam et al. (2005): In 1980, Lloyd, one of the largest retail chains in the United Kingdom, created and published its financial statement without taking into consideration the accounting and audit regulations since the latter one was not in force. Defaults of information flow between branch offices and management could be traced back to the lack of modern and uniform accounting standards. Different sales values and funds were indicated by the branch offices and by the headquarters due to differing accounting principles and method and self-interest.

Concerning decisions on fund assessment and investments Smith (1996) gave the following example for the misuse of accounting standards: The Coloroll share company operation in the United Kingdom grew to ten times of the original company within four years thanks to acquisitions but kept a low rate of (fictive) profit by using accounting tricks, "creating reorganizing reserves." Next year its capital has degraded and bankrupted. The Accounting Standard Board (ASB) has created and published unified principles and accounting methods to avoid such misunderstandings, differences, and failures among economic entities participating in the division of labor. Their aim was to eliminate bankruptcy in such large company as the British Coloroll or the American WorldCom. The board consisting of accounting researchers, experts, and auditors aimed to create standards that prevented the management from misinforming shareholders concerning the profit achieved by the company or the amount of dividend. In addition Botsari and Meeks (2008) have created accounting methods that restrain management from altering former performance results. A similar case has been published recently in Hungary: the First Hungarian Natural Gas and Energy Trading and Service Provider Ltd tried to alter its profit by self-revision to "achieve" loss. Sodestrom and Sun (1996)—in their study—introduced methods that may prevent company management from misinforming shareholders by motivating then to apply accounting standards especially in the statements of their performance and funds.

Adoption of the International Financial Reporting Standard (IFRS) may lead to less time being spent trying to be in line with all the strict rules and regulations that come with the national rules-based accounting. Western European and American multinational corporations have often been outsourcing their accounting tasks to lower cost countries. If a globally accepted financial reporting standard was available, it would be even more likely that companies would contract out their accounting tasks to lower cost countries. Currently, the management of companies from developed countries might be concerned that they do not find the necessary accounting expertise in developing countries. With the adaptation of the worldwide accounting standards, companies could centralize accounting training and could easily set up centralized financial support centers. The number of shared (financial and administrative) service centers could increase considerably. This would benefit the multinational corporations and create a significant number of new jobs in developing countries. With globalization under way, accounting professionals could easily reallocate (especially in the European Union where there are no country borders anymore) to other countries as accounting and financial statement would have a common language. The companies in countries like India, Mexico, or even Hungary have more and more duties taken over from the firms of developed countries and from other organizations. The market is developing because there is a demand and supply and accounting harmonization can produce simpler and more attractive systems.

On the basis of the standard reports the fiscal and the economic situation of the companies becomes more transparent and comparable among the different countries. The unified standards especially favor the smaller investors' interest because it is most difficult for them to examine and compare the data of the statements of different countries. The cost of acquiring the information will be much lower. This transparency and comparability boosts the process of international division of labor at a standard world market too. So it will be much easier for investors to place their investment to the joined countries, and they can harness the comparative advantages of the international division of labor.

Regarding the division of labor, an obvious advantage can be identified in the case of companies with global operations and foreign reporting requirements. Such benefits include the ability to streamline reporting and reduce related costs by developing common reporting systems and consistency statutory reporting. Such companies could develop regional financial centers, relocate finance resources depending on where they may be needed, and centralize training and development efforts.

INTERNATIONAL ACCOUNTING HARMONIZATION AND FINANCIAL INNOVATION

Statement that the harmonization has a leading role in innovation is proven in numerous studies, for example, Temple (2005). According to data provided in this study, 50 percent of the interviewed person conceived that accounting standards promote innovation. The other 50 percent stated that standards restrain innovation. This includes the group that feels standards may both promote or restrain innovation. This could question mark the role of standards in innovation. As mentioned earlier and argued by Smith, division of labor promotes innovation. New markets could be achieved by using standards and thus new markets entries and products may give a significant boost to innovation—as argued by Bae et al. (2008).

Using widely accepted standards for innovative products can also result in better sales figures. Without these standards, low-quality products and remaining stocks cannot be relocated, and thus innovation would lose its economy-boosting effect. In addition, new standards expand the scale of innovative products; thus in market entries without new standards, innovative products can hardly be obtained. Loan contracts may also provide us with a perfect example of the role of standards in financial innovation. Therefore, the accounting standardization process has already taken a significant part of such contract, but for now adapting this information for performance assessment has become more and more complex. Fluctuation of interest rate is highly influenced by innovation (Easley and Hara, 2004). This takes account of the fact that higher risk advantage can be achieved through lower interest rate and lack of negotiations before signing contracts. On the other hand lenders are compensated by means of the extra premium in the interest rate. With such a warranty, a lower interest rate could be set, and thus both lender and debtor could come to a beneficial arrangement. Even so, in some case—for example, as seen in the study by Fearnley and Sunder (2007)—terms indicated in the contract were defaulted due to false determination of profit, lowered loan risks "accounting tricks," or defaulted payment of installment. Thus uniform contract and standardized international accounting methods should be introduced.

In many countries the growth of financial leasing has proved that leasing is like a financial innovation that has obtained a long-lasting position in economic life. The success of leasing could be explained by the arising needs of financial capacity in the economy, and not the temporary favorable environmental conditions. Alongside the clients in the frame of financial innovation there is an increasing demand for services and goods for handling wealth, and for that, to have a higher benefit in case of unfavorable financial conditions.

Nowadays, in many countries the accounting systems do not primarily put the interests of the investors first, but rather that of the credit banks and tax aspects. The introduction of the IFRS helps countries to converge their accounting systems to the Anglo-Saxon model, where the report is made on the ground of the aspects of the investors. The standard system could help to spread the financial innovations in a wider environment, because the IFRS is similar to the Anglo-Saxon approach and it is the most efficient where there is a prosperous capital market. It would support the spread of the financial innovations worldwide and unified attendance in the accounting systems.

THE EFFECTS OF INTERNATIONAL ACCOUNTING HARMONIZATION ON THE TRANSACTION COSTS

Naturally financial markets may not be misleading with accounting tricks for good. Despite the fact that information concerning market prices could not be published by using international accounting standards, it remains essential to assess stock prices. If an economic entity has a semimassive effect in a country, stock prices will react to published information irrespective of what principles or method were used in financial statements.

Literature (e.g., Bradshaw et al., 2008) consisting several events proves that in many cases market participant did not react to changes of reports (performance, profit and loss statements) mainly owing to a shift in used standards. For example, an economic entity changed its amortization method to achieve higher profit rate. Since market participants had enough information that the increase in profit was due to amortizing assets, the stock price of the given entity has not risen.

Similar effects could be experience in case of mergers and acquisitions in the United States (Feleage et al., 2008). Since market participants were not touched by the fact, that increased profit was due to amortizing assets not performed before merger. Consequently, standards should be used to eliminate manipulations, extra work caused by the alternations, and unnecessary costs.

Another part of transaction costs are affected by international accounting standards, for example, costs connected to signing a loan contract or a so-called contract. Accounting data may limit contracting parties' freedom in the sense of how data could be used and represent their interest, for example, information provided by loan contract on debtor's engagement or limitation of the liability management.

Invoice of business tax may be mentioned as a theoretical example of so-called contracts since EBT (earnings before taxation) and EAT may differ significantly and the latter one is to be modified by accounting standards, rates, and indexes. It is especially typical to the third sector where income is strongly affected by international accounting standards.

Swann (2007) highlights the cost-saving effect of international accounting principles in connection with contracts since without their standards, lenders would be forced into contracts that may push them toward bankruptcy.

Both lender and debtor prefer accurately defined obligations and demands that may be detailed by international accounting standards. Efficiency of loan contracts may be increased by using more transparent, comprehensible, and comparable reports based on international accounting standards since misconceived reports may lead to losses or decreasing assets. These losses could be derived from false assessment of assets, obligations, consolidated profit, or net assets. Since information on which reports are based may not be compensated from other resources, it motivates market participants to rely on such reports and decrease the risk of investments.

In order to promote the outcome, a standard-setter must explain its view of the economics of transactions in the objectives to the standards. If there are competing views about how to faithfully represent the economics of a transactions, then the standard should state whether there is more than one acceptable treatment and why that conclusion was reached. Preparers and auditors could then use this information to reconcile the economics of a transaction to their understanding of the objectives of the standard-setter. Investors want to understand the fundamental judgments being made by preparers and external auditors. Under a more principles-based system, both preparers and auditors will increasingly be called upon to exercise sound judgment as a replacement for rigid adherence to the compliance process of a rules-based system. This is a positive development, as it will promote clear and understandable financial statements that faithfully reflect a company's economic condition. Yet at the same time, it is clear that a system relying on judgment requires that those judgments be clearly communicated in order to ensure comparability.

Applying international accounting standards may also decrease the costs of data processing systems since it stores and processes differed data. The more standardized the financial data base, the higher the benefit gained. Decreasing risk connected to the operation of data processing systems may affect (decrease) stock prices since shareholders expect increase in performance. Unified international accounting principles may enhance cross-border investments, increasing their benefits. Since accounting standards may enhance the ability of forecasting profit rate, it could act as potential opportunity for investors.

The transaction costs of investors decrease with the steps taken in the direction of a single presence of stock markets, the disappearance of different national regulations. The costs regarding accounting, auditing, and international comparison will decrease with uniform reports instead of expertise needed for the summarization of several types of reports and comparisons. With the use of numerous different accounting and reporting standards, it is very difficult for companies to benchmark themselves against their competitors.

Businesses with foreign operations have to use different national accounting standards to complete their consolidated financial statements. Auditors (both internal and external auditors) have to be experts of each applicable national accounting standard or law of the multinational organizations' subsidiaries to be able to properly review and validate the accuracy of the company's financial reports. If the IFRS was adopted worldwide, auditors could work more effectively with significantly less people. Also, smaller audit firms could review and validate the financial statements of multinational companies. Currently the four big audit firms (Deloitte, E & Y, KPMG, and PWC) seem to be auditing most of the big internationally recognized corporations as they have operations (with the necessary expertise) in almost all countries around the world. I believe that IFRS could bring increased competition in the auditing field, which could reduce the unavoidable audit costs.

Due to experts' opinions and impact studies, profit increasing effect of international accounting standards through cost-saving (transaction costs, costs of management) is proven.

INTERNATIONAL ACCOUNTING HARMONIZATION DECREASES COSTS OF CAPITAL

Practically speaking accounting is an instrument to project economic transactions and assess their performance. Particularly the latter could be a remarkable tool for financial market participants if it indicates accurate data on the financial situation, performance, mobility of resources, obligations due of examined business. Domestic investors prefer domestic business since reports are created according to well-known international accounting standards and could be interpreted easily. On the other hand foreign investors prefer reports created on the basis of international standards rather than domestic standards. Costs of foreign investments could also be reduced if invested to the optimal opportunity where cost of managing active investments could be reduced to minimal level while maximizing profit.

About one thousand foreign companies registered at the Securities and Exchange Commission (SEC) converted their accounting reports from their national accounting rules according to US GAAP and are listed and traded on the stock market of the United States. But only some of them have investment instruments (instrument of governance, ability to classify and account activities, ability to initiate claims) that are commonly used in the United States, exposing them voluntarily to the risk of being sued on the basis of insufficient investment-protection. Thus risk of exchanging stock may also increase the cost of capital since it is connected to the risk level of investment (decreasing risk factors results in the decrease of transaction cost emerging during investment). Risk may include the reliability of the accounting statements of business' financial position and its performance. The cost-saving effects (through decreasing risk level of assets) of reliable and true financial statement are proven by numerous studies (including Butter et al., 2007; and Camfferman and Zeff, 2006) since reliability of accounting data affects the price of assets. The aforementioned studies have pointed out that only that management could take effect on the cost of capital, which has provided exact and reliable information to shareholders. Accordingly international accounting standards and unified methods could assist shareholders since unreliable reports could mean a possible risk-factor. This accounting model based on the principles of historical costs for invested vehicles distorts its real value. It can be defined as realizable income after selling it and achieving some financial resources in the cash flow statement. The invested vehicles receive criticism nowadays that may lead to financial resources' evaluation. The necessity for reevaluating applied international standards of the financial instruments was suggested by experts due to present subprimed mortgage and economic crisis.

Uniform financial reporting standards will result in a lowered cost of capital because the investors are willing to accept lower returns (interest on debt, dividends, and capital appreciation on equity) from their investments in corporate securities. Investors can reach lower returns when the perceived risk of their investments is reduced. Risk is a function of many factors, but accounting risk refers to the risk in investing that derives from difficulties in understanding the accounting principles being applied by the reporting entities, and the possibility that financial reporting standards may not be uniformly adhered to. Another aspect of accounting risk arises from the inability of users to process the information. If measurements and disclosures are of such complexity that the investors cannot understand this information when making decisions, they will perceive greater risk and demand higher expected returns, therefore reaching a higher cost of capital too. This risk originates from the fact that the accounting directions are not clear and common for use by different companies.

There is also risk based not on the underlying financial reporting principles, but on the confidence that the reporting entity has faithfully applied to them. This depends on the investors' belief in the regulatory regime overseeing financial reporting (e.g., SEC enforcement) and on the auditors' capabilities and willingness to enforce GAAP or IFRS rules. While auditors' honesty is challenged (such as in the Parmalat case that had happened in Italy), the reluctance to confront clients opting for aggressive interpretations of accounting standards is more widely acknowledged. Hence, reducing accounting risk should have salutary effects on the cost of capital. A number of academic studies have investigated this premise, which is positive on the whole, although there is not unanimous support for this proposition. Investor confidence in a given entity's financial reporting depends on more than the financial reporting standards it claims to subscribe to.

Examining accounting standards from a different point of view confirmed the fact that unreliable information used in reports may further increase cost of capital. The complexity and misconception of financial statements may cause higher risk factors resulting in longer rate of return and higher costs of capital. Without doubt it may be concluded that accounting risk could be lowered with the use of reliable and true international accounting standards.

Shareholders blindly trusting in published reports may become a risk factor as well. It also depends on the extent to which shareholders trust the regulations over financial statements (e.g., SEC in the United States), technical background, and knowledge of auditors to enforce international accounting standards. Considering all the aforementioned factors, it could be declared that increasing reliability and better interpretability of information provided in financial statements could decrease investors' cost of capital. Besides direct risk factors, indirect risk factors also affect investors' cost of capital.

Reporting according to IFRS provides much better access to world capital markets, which reduces the cost of capital. Investors cannot easily interpret the given countries' national financial reports. They are very reluctant to invest in companies without clear financials. It is high risk to invest in companies without easily accessible, clear financial reports. Investors expect higher returns from these companies, and thus the cost of debt is higher for companies not preparing IFRS reports. IFRS would put the financial statements in a simple and understandable form for investors and other businesses interested in the firm; IFRS financial statements could have a positive effect on companies' credit ratings and thus the cost of borrowing may be reduced. Also, IFRS are widely accepted as the financial statements framework for companies who would like to get listed on any of the world's stock exchanges. Since worldwide adoption of IFRS would create a common language for accounting, new capital markets would open to companies who have been reporting only in accordance with their national standards. One can easily say that companies have the opportunity to prepare their statements according to IFRS. However, small and middle-sized companies do not have enough funds and manpower to complete their financials both according to the national standards required by the law and according to IFRS, which would be desirable to enter the international capital markets.

In an increasingly global international environment a better developed international financial reporting system is becoming more important by the day. The advantages of more standardized national accounting rules and more comparable financial report are manifold. One of these advantages is the decreasing cost of capital. Investors may accept lower returns (interest on debt, dividends, and capital appreciation on equity) if on the other hand they only have to take lower risks. This is true if the international standards are properly enforced by the regulatory regime.

It seems to be apparent that appropriate accounting standards contribute to the division of labor, to financial innovation, to the reduction of the transactional costs and the cost of capital, and even to the increase of the enterprises' earnings.

6. Comparative Statistical Analysis

In this chapter the author first measures the differences between the domestic accounting rules and the international methods inside and outside of the European Union (EU), and then evaluates and analyzes their effects on the business environments.

The author used Nelson's Directories of Investment Research for providing information on nearly 800 research businesses (especially multinational companies) around the world, including the 67 member enterprises of the Budapest Stock Exchange during the period 2010–12. He has chosen 400 of the biggest (by the total amount of their assets, net sales, and employees) international European businesses (e.g., Daimler Chrysler, Allianz, ING, Gazprom, Arcelor, Credit Suisse, and Deutsche Bank) and 300 multinational representative companies from the American, Asian, and Australian continents. The researcher adopted two approaches in this study. The first involved identifying a list of 16 important accounting standards based on a review of the past literature and relying on a recent, comprehensive survey of general accepted accounting principles (GAAP) differences. Second, the author selected 20 EU and 27 non-EU member states—representing every continent excepting Africa—from where he could obtain accounting information. As the tests examine the effects of GAAP differences between the local accounting rules of businesses and international standards, it excluded firm-years from the primary sample when businesses do not use local rules based on Worldscope yearly database. Worldscope data on the accounting standards used by the company are available for approximately one-half of the sample. In the primary test the author retains businesses that do not have data on the accounting rules used by the firms, reflecting the assumption that smaller businesses without standards data are very likely to be local rules users.

This survey contains information on how local GAAP differs from international accounting standards (IAS) on incorporating recognition, measurement, and disclosure rules. For each country, the survey captures the manner in which the standards differ from IAS:

- absence of recognition and measurement rules that are present in IAS (e.g., many countries do not require international standards);
- absence of disclosure rules that are present in IAS (e.g., common disclosures that are called for under IAS but not required under local GAAP);
- inconsistencies between local GAAP and IAS that could lead to differences for many enterprises; and
- other issues that could lead to differences between local GAAP and IAS for certain enterprises.

THE ACCOUNTING PECULIARITIES OF THE MEMBER STATES OF THE EUROPEAN UNION

First, the author chose eligible countries inside the European Union according to the research. In the study 16 international standards content and characteristic were compared with the international accounting rules and standards. Five of these standards (1, 7, 8, 14, and 25) play a crucial role in the comparison of the accounting reports. The IAS 2 standard is to prescribe the accounting treatment for inventories; the IAS 17, 36, 38 standards are in connection with tangible and intangible assets; the IFRS 7 pertains to the disclosure and presentation of the financial instruments; the IAS 19, 37 contain the regulations in connection with the other liabilities and debtors; the IAS 12 and IFRS 5 detail the special accounting practices; while IAS 27 and IFRS 3 are about the accounting of the Combinations by Contract, Alone or Involving Mutual Entities. Thus it can be concluded that the standards used in the sample sufficiently represent all areas of accounting, particularly the rules about the setup of the accounting report. He analyzed the member states of the EU separately because the previous regulations (e.g., the 1606/2002 on the application of IAS), directives (e.g., *78/660/EEC*, *83/349/EEC*, *2006/43/EEC*), communications (e.g., COM/2003/283), and recommendations (e.g., C/2000/3004) made by the EU were in order to implement the accounting harmonization and the common accounting principles. He compared the international standards with the domestic accounting principles and rules per its components. He only declared them as harmonized if they show a complete match. These specifications were made with all 16 standards for all countries. He calculated the deviation between the international standards and the domestic regulations and principles in the eligible countries of the EU in percentages and summarized it in figure 6.1.

According to figure 6.1 two opposite tendencies can be identified. In connection with the continental European countries the deviation from the international standards is greater than in the case of the two island nations (Great Britain and Ireland). The greatest deviation from the international standards could be identified in the case

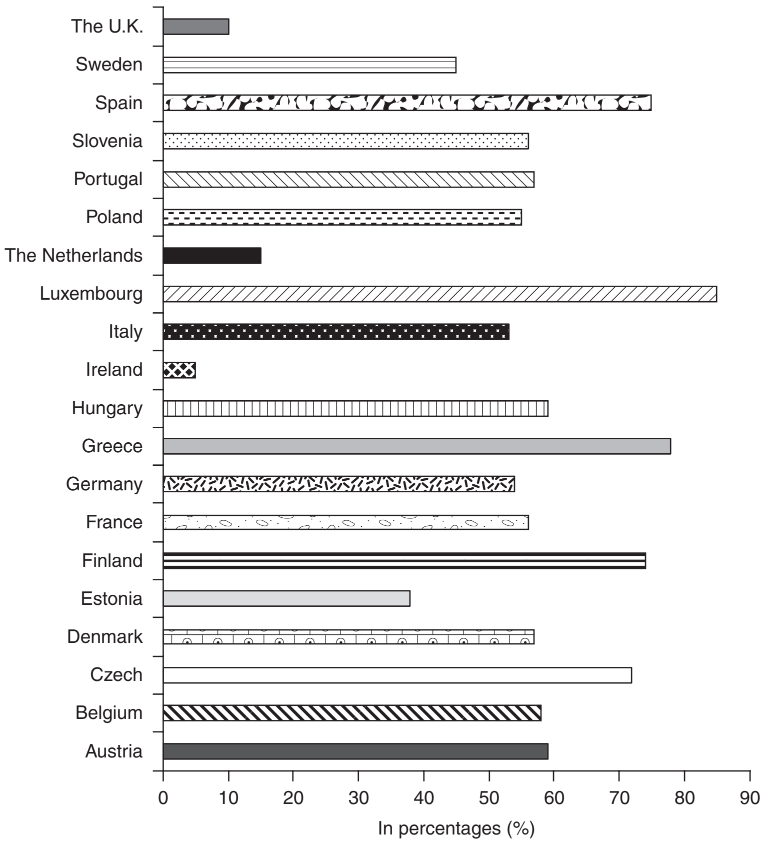

Figure 6.1 Differences between domestic accounting rules and the IAS in the EU.

of Luxembourg (over 80 percent). The Commission of the European Communities warned (e.g., the European Court's C-115/05 judgment) its member nation to take steps necessary to comply with Directive *2001/65/EC* of the European Parliament with regard to the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions.

Europe is the origin of many legal systems: English, German, French, and Scandinavian. Prior to 2005, there were country-specific accounting systems. Therefore the EU issued several communiqués, commendations, and directives to harmonize financial reporting practices to reduce diversity and facilitate cross-listings and cross-border investment.

The EU countries have been divided into two groups depending on their finance, legal, and tax systems. According to many researches, countries with a code-based legal system and a business financing structure that is primarily based on banking are characterized by a strong tax influence on accounting and, therefore, by the presence of governmental rather than professional regulatory bodies. On the other hand, countries with a system based on common law and with a well-developed capital market have issued accounting rules independently from tax rules, under the auspices of professional bodies. Under these circumstances, we make the hypothesis that the investor-orientated legislation in common-law countries versus the creditor orientation of code-law countries will imply a higher value relevance of earnings than book value in common-law countries and vice versa (Acre and Mora, 2002). The Netherlands, in spite of being a code-law country, has been typically included in the Anglo-American group due to the characteristics of its accounting system. So, for our purpose, we consider the United Kingdom and the Netherlands in the Anglo-American group and Belgium, France, Germany, Italy, Switzerland, and Spain in the Continental group.

The classification of the domestic accounting systems can be divided into two categories: those with significant equity markets and outside shareholders (the Anglo-Saxon model) and those with weak equity markets and few shareholders (continental European model). Consolidated (group) accounts drawn up under UK, US, or international accounting standards would typically fall into the former group, while examples of the latter would include individual French, German, and Italian accounts (Sodestrom and Sun, 2007).

The law system of most of the continental EU member countries is based on the principles of the Roman law (jus civile). The codification of the law characterizes these countries. In such a legal environment the adaptation and implementation of international accounting standards into the national account system is much harder and takes longer. Because of this and as the data of figure 6.1 also show us, the deviation from the international accounting standards are much bigger in these countries, although in a varying degree, than in the case of the island nations of the EU. Inside the accounting systems of the continental Europe we can differentiate three accounting clusters: Germanic, Latin, and Scandinavian. The accounting system in the Germanic states (Austria, Germany, Hungary, Czech Republic) is in many ways different from that of the Anglo-Saxon and Scandinavian countries. For example, the company and tax law in Germany plays a pivotal role in accounting. Also in Germany the Commercial Code contains the account reporting principles. Half of the German accounting principles differ from international standards because their account law doesn't contain rules in connection with the effects of the exchange rates in case of foreign-based subsidiaries; the review of the value adjustment after the nontangible assets lifespan exceeds the 20-year limit; the publishing commitments in case of the change in the capital and reserves; the financial instruments valuation at fair value; disclosure commitments in case of related undertakings and the rate of dividend per share. There is no consistency in the accounting of business combinations, in the case of the accounting of leases grouped by tax provisions, and also in the evaluation of the assets.

It is obvious that the Anglo-Saxon (or Anglo-American) accounting system differs from that of continental Europe, Asia, Latin-America, or any other country of the world. In the case of Anglo-Saxon countries the stock exchange plays a significant influential role in national accounting practices, but does not play a cardinal role in the regulation process. In Great Britain the company law contains the necessary accounting requirements not just in case of the Limited Liability Companies but also for stock exchange–listed companies. Besides, not just the whole accounting profession but also, to a lesser extent, the stock exchange participates in developing the domestic accounting regulation system. The country established its own professional bodies responsible for the regulation of accounting. One of these bodies is the ASB (Accounting Standards Board), which has the authorization for issuing National Accounting Standards. The accounting regulation works in a similar manner in Ireland too. The law system of the Anglo-Saxon countries (common law) does not contain rules in connection with the behavior of the companies or the preparation of the annual accounts. In such circumstances accounting doesn't have a subordinate role. Instead practical and theoretical accounting professionals create standards very similar to the international ones, since the latter are having a major effect on their national standards. In such economic environment the adaptation and implementation of international accounting standards into the national account system is much easier and faster than in the case of the Continental European countries introduced in the next paragraph.

Hungarian accounting shows many similarities with other continental, mainly Germanic, cluster members according to the place and classification. Its law system is similarly codified, so the accounting principles were also expressed by law. Since 1991 the interest of the owners and the creditors stands at the center of the regulations, which also takes into account previous taxation goals. However the previously pivotal role of economic alignment and taxation is now a thing of the past. We will discuss the classification of the individual standards later, but here, according to the information from the domestic stock exchange–listed companies and from personal consultations, we can assume that the Hungarian account regulation, the budget system, its accounting principles, and evaluation methods constitute a solid ground for the establishment of an IFRS financial statement. From the balance drawn up according to the national rules only some corrections (e.g., depreciation calculation after value adjustment, decreasing the revaluation reserve with calculated depreciation cost of the asset, and moving the accrual capital's consolidation margin to the profit reserve) and renames (reclassification of the accruals and deferred income and the prepayments and accrued income, the reclassification of the property rights and payments on account in course of construction) will lead us to the IFRS balance sheet. In case of the statement of revenue the reclassification of the given discounts and refunds as turnover lowering and the received discounts and refunds as material cost lowering elements, and, furthermore the reclassification of the extraordinary elements and the value of the allocations for depreciation higher with value of the depreciation after the value adjustment also lead us to the IFRS balance sheet. By the time of the socialist economic system the Hungarian accounting principles always followed the Hungarian economic regulation system and the modifications of the taxation system in the 1980s as a chapter of the law on national finances. After 1991 accounting became an individual act that considered the European rules (directives), and from 2001, after its recodification, the international principles as well. The commission review before joining the EU (2004) declared that the Hungarian national accounting rules were compatible with the accounting principles of the EU. Although some financial "scandals" (Postabank in Hungary, Parmalat) derogated the faith in accounting, just like in other countries, for example, the United States (e.g., Enron in United States), the accounting regulation of Hungary is considered stable and reliable. Furthermore, the national standards (leasing accounting, inventories, accounting policy regulations), developed in the last few years by the Ministry of Finance is aimed toward closing the gap with international standards.

The national regulations of the Latin cluster countries (Belgium, France, Italy, Portugal, and Spain) show several similarities with the Germanic cluster, such as the pivotal role of the company and taxation law, but they also differ radically from Anglo-Saxon characteristics. In France, for example, the codification rules are similar to the Napoleonic code (also in connection with accounting). In Italy, just like in other countries with conservative traditions, the accounting rules gave rise to minimized taxable profits and dividends for ventures. It is not unusual for the accounting information to serve several different purposes (management, tax authorities, and owners) simultaneously. The similarities between national regulations of the countries in the Latin cluster and international standards also touch a minimum of 50 percent, but sometimes reach 80 percent (Spain).

The EU states in the Scandinavian cluster (The Netherlands, Denmark, Sweden, and Finland) also show several conformity with the Anglo-Saxon countries but we can find some important Germanic effects as well, for example, the importance of the tax legislation. Among the Scandinavian countries The Netherlands differs the least (only 15 percent) from the international standards. In Holland the impact of the micro-economical approach to the account is reasonable. Nevertheless, the country also shows several similarities with the Anglo-Saxon characteristics. The pivotal role of the company law and the accounting profession is also measurable here. The civil law contains the company law, which is based on the principles of Roman law. In this respect it shows analogy with the continental European countries, except for the civil law, which traditionally does not play the role of a detailed regulatory system.

National generally accepted accounting principles (GAAP) in "code-law" countries were more frequently accused of abusing transparency due to legally imposed techniques such as statutory reserves, but failures even under "common-law" national GAAPs have also been widely cited. But the IFRS-based financial reporting will ensure reasonable accomplishment of financial statement objectives. National GAAP have commonly been categorized as being designed for either code law or common law traditions, with most continental European GAAP and Japanese GAAP being examples of the former, and US GAAP, UK GAAP, and IFRS (which was largely derived from US and UK GAAP) being typical of the latter. It is noteworthy that countries moving from code law–based GAAP to IFRS will experience a more substantial change in financial reporting standards than will those moving from common law–based GAAP to IFRS.

THE ACCOUNTING PECULIARITIES OF COUNTRIES OUTSIDE OF THE EUROPEAN UNION

After the EU countries, the differences in the accounting principles of American, Asian, and African nations, European countries outside the EU, and also Australia and New Zealand and the international accounting standards need to be analyzed (figure 6.2).

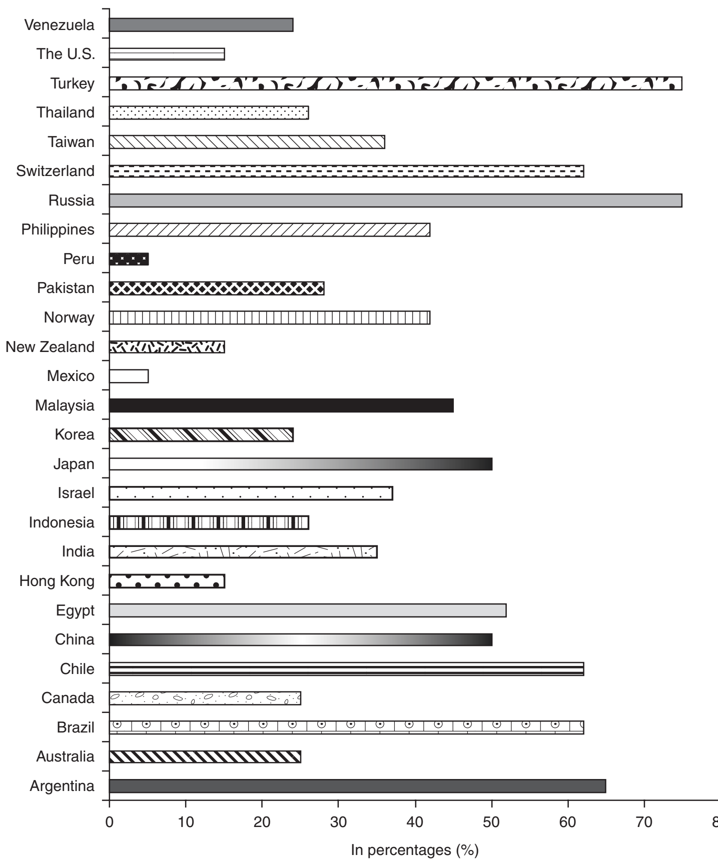

Figure 6.2 Differences between domestic accounting rules and the IAS outside of the EU.

Besides Russia and Turkey the differences between the accounting principles in countries mentioned earlier and international accounting standards are less (it does not reach the 50-percent mark) than in case of the EU member states. Among the European countries Switzerland follows the Germanic accounting principles and its difference from the international standards is nearly the same (62 percent).

Swiss accounting is among the most conservative and secretive in Europe and the world today. As in Germany, Swiss accounting practice is dominated by company tax and the tax regulations governing the accounting profession, which is small and still in the early stages of setting accounting standards. The legal requirements relating to accounting are modest and still permit the creation of secret reserves.

Norway's accounting principles reflecting Scandinavian effects and the deviation is similar to the Swedish. The accounting rules in Asian countries follow the colonial specialties, and so the impact of the colonizers is high. Thus Dutch influence can be seen in the case of Indonesia, Anglo-Saxon influence in case of India, Pakistan, Hong Kong, and Malaysia, and Spanish and American impact in the case of the Philippines. In the case of the Chinese accounting system it was affected by both Western and socialist Russian influence. A more micro-oriented decision-making approach is thus being encouraged; this retains a measure of macroeconomic control—a difficult balance to strike given China's tradition of uniformity and detailed regulation. Moreover, this tradition appears to be consistent with established Chinese cultural values and hence will be difficult to change. The new accounting standards, structured as a basic standard and as a series of specific standards, represent a major change of approach in Chinese accounting in that all enterprises are now required to comply with a unified set of accounting principles. In case of Japan we can see both Germanic and American influence. Despite the significance of the stock market, the accounting tradition in Japan gives preference to the information needs and priorities of creditors and the tax authorities. The government has been a major influence on all aspects of accounting, and the corporation tax law is another major, if not overriding, influence on income measurement practices in that corporate tax returns must be based on the annual accounts approved by shareholders. Government institutions are directly involved in accounting standard-setting. With accounting systems under the jurisdiction of two government institutions, there is no unified approach to regulation. In fact, a number of large listed corporations are obliged to prepare two sets of financial statements, one required by the commercial code and the other by the Securities and Exchange Law. The accounting profession is small and has lacked influence in the accounting standard-setting process, but it provides recommendations on the practical application of the legal accounting regulations (Radebaugh and Gray, 2007). However, the accounting systems in Asian countries are getting closer and closer to the Anglo-Saxon model.

The accounting in Argentina and Brazil follows the Latin rules and the difference is also similar (65 percent). As in France and Italy, the accounting tradition in Brazil gives preference to the information needs of creditors and the tax authorities. As in other Latin countries, the influences of government, company law, and the taxation regulations on accounting are of fundamental importance. The accounting profession in Brazil is not as well developed as in the Anglo-Saxon countries, but the institute for Brazilian accountants issue accounting standards that form the basis of generally accepted accounting principles. The United States is famous for its accounting standards, which follow the Anglo-Saxon traditions and similarly to the British and Irish system it differs only marginally (15 percent) from the international standards. Mexico and Canada as former British possessions and members of the North American Free Trade Agreement (NAFTA) follow the Anglo-American (Anglo-Saxon) accounting principles. Australia and New Zealand also as former British possessions follow the Anglo-Saxon accounting principles, and differ only to a small extent from international accounting standards (15–25 percent).

EVALUATION OF CERTAIN ACCOUNTING STANDARDS

After evaluating the individual countries and the group of countries, the author analyzed the average differences pertaining to certain accounting standards and also the background causes of these differences. These differences are shown in figure 6.3. The researcher observed that the biggest average difference is detectable in case of the IFRS 7 (until 2007 IAS 30, 32) standard both within and outside the EU (82 and 68 percent, respectively); this standard deals with the disclosure and presentation of financial instruments. The author remarked that in this case the countries did not claim the disclosure and presentation of the financial assets and obligations on their fair value in their financial report as regulated in the accounting standard. This remark also stands in the case of Hungary. Hungarian national accounting regulations make the evaluation at fair value possible, but not compulsory. According to accounting practitioners only a few businesses choose this option. Personal consultations show that this is because of the tax consequences of this new model. Another typical difference is in relation to the IAS 37 Provisions, Contingent Liabilities and Contingent

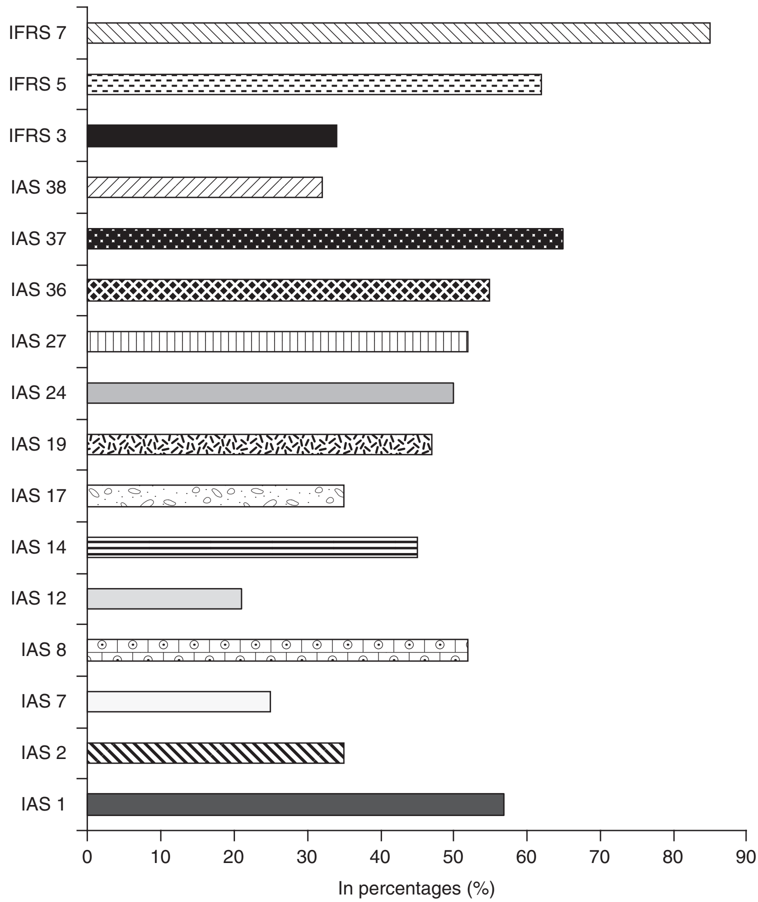

Figure 6.3 Differences between domestic accounting rules and the IAS by standards.

Assets standard (68 and 80 percent, respectively). On investigation, it turned out that there are no national regulations in connection with the making of provisions; furthermore, it can be made in cases when there are no liabilities and no special rules of readjusting the provisions. In the case of Hungary, the researcher found the two previously mentioned differences. This is because its act on account does not require that the provision originate from a previous event; furthermore, provisions can be made in advance in case of the periodically repetitive costs, and it does not use the present value. There is a significant difference in case of IFRS 5 (IAS 35 until 2005) and Noncurrent Assets Held for Sale and Discontinued Operations standard (65 and 55 percent, respectively). In international accounting there are no regulations referring to Discontinued Operations. Also, our national act on account does not require information on the Assets destined for sale or used in Discontinued Operations. It only orders the holder to demonstrate its future goals in the annual report, which lists all the Discontinued Operations and the Assets destined for sale.

In the case of non-EU countries the difference in connection with the IAS 19 Employee Benefits standard is also typical (65 percent), whereas in the case of related EU countries this ratio is only 45 percent. The readiness of the regulations in connection with the cost of providing employee benefits and the costs above the pension benefits was not easily estimable. In case of Hungary only the first half of the sentence stands. Hungarian regulation tries to follow international standards as far as termination benefits are concerned. But it only admits the benefit as severance pay, which the employee gets if the employer terminates his or her services before the retirement period.

The difference between the national regulations and IAS 36 Impairment of Assets standard exceeds the 50 percent mark both in case of the EU and non-EU countries. As there are no detailed rules in the domestic regulations on the testing of the impairment of the assets, the accounting of the impairment is made only after it is declared durable. The Hungarian domestic regulation also differs in that there are no precise instructions regarding when to evaluate the "reference" value, although it does not mention the external or internal signs of the impairment and the readjustment of the impairment. Furthermore the category does not refer to the accounting date, but it relates the market value on the date of making the balance sheet to the book value on the accounting day.

We can see a difference of 55 percent in relation to the IAS 1 Presentation of Financial Statement in the case of the EU member states only. Separate listing of the changes in the capital and reserves is not present in the member states' accounting statements. This is also the case with Hungary. But in the notes on the accounts the important changes in the capital and reserves by entitlements must be demonstrated. So, in my opinion, this should be considered not as a substantial but as a formal deficiency. A further 52 percent difference between international standards and EU regulations is seen with regard to the IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, and this applies for Hungary as well, because it allows a broader interpretation of the unforeseeable event. Hungary's act on account does not differentiate between accounting policy and accounting estimate. It considers the estimating as policy. The accounting policy contains rules relevant to stock-taking, money handling, evaluating, and net cost calculation. Furthermore all errors found must be corrected. In case of a substantial error the corrected account must be represented. By contrast, international regulations do not follow this method.

Finally there are some smaller, marginal differences that mostly affect the EU member countries. This includes the IAS 24 Related Party Disclosures standard, which has an average deviation of 52 percent, and the IAS 27 Consolidated and Separate Financial Statements standard with the average difference margin of 53 percent. The latter deviation occurs due to the fact that there are negligible disclosure requirements in the domestic accounting regulations. The Hungarian act on accounting does not include the list of such events. However that kind of information must appear in the notes on the account. Moreover in the Consolidated and Separate Financial Statements the requirement for consolidation of special activity companies is missing. This deficiency does not affect Hungarian regulations.

The differences are much lower for other standards. This is especially the case with non-EU countries (the average deviation is around 5–35 percent), but the margins are low even for EU member countries (less than 50 percent, i.e., around 22–35 percent). The smallest deviation detected among non-EU countries is in the case of the IAS 7 Statement of Cash Flow standard (5 percent), while in case of the EU member countries it involves the IAS 12 Income Taxes standard (22 percent). For Hungary differences were detected in the case of standards Business Combinations, IAS 7 Statement of Cash Flows, and IAS 38 Intangible Assets.

This research records the following notes for few other standards:

- IAS 2 Inventories standard: When using LIFO asset-management and valuation method there were no disclosures of the related values at FIFO asset-management and valuation method. (This is not a problem for Hungary as it uses LIFO and average costing asset-management and valuation method.)
- IAS 7 Statement of Cash Flow: The cash flow itself is missing from the account regulations of some countries (not so for Hungary).
- IAS 14 Segment reporting: Segment reporting is not at all or just partly compulsory. (In Hungary segment reporting is only mandatory for stock exchange–listed companies.)

- IAS 17 Leases: The activation of the leases is missing or just partly done. (In Hungary the lease must be shown only in case of tied and long-term calls.)
- IAS 38 Intangible Assets: The activation of Research and Development, Trademarks and Brand names. (In Hungary the standard is considered harmonized.)

7. Effects of Universal Information Methods on Company Performance

This chapter traces the benefits of universal information methods and their contribution to harmonization in business practice. With increasing globalization of the marketplace, international investors need access to financial information based on harmonized information methods and procedures. It is expected that the unified accounting information system will lead to new types of analysis and data, with the possible integration of new indicators from the business management practice of certain countries. The universal information methods are becoming one of the most efficient tools for company performance measurement and evaluation.

My research is based on a qualitative comparative approach. In order to identify the results of my scientific research about the universal information methods in Hungary, I have elaborated on the following hypotheses:

1. Hypothesis 1: Businesses with lower labor productivity compared to their industry peers have greater incentives to adopt universal information methods.
2. Hypothesis 2: The sensitivity of CEO turnover to accounting earnings increases after the adoption of universal

information methods. Earnings and stock returns affect management turnover.
3. Hypothesis 3: The sensitivities of employee layoffs to accounting earnings are before and after the adoption of universal information methods.

To analyze business adoption decision, my sample consisted of Budapest Exchange Trade (BET) companies who, as a rule, adopted international financial reporting standards from 2005. My final sample comprised 65 IFRS (international financial reporting standard) adopting and 260 local (Hungarian) accounting rules firms. For choosing the domestic accounting rules user enterprises, I introduced mathematic-statistic methods. An alternative approach it to create a matched sample of local rules businesses based on criteria such as year and industry. All local rules firms were included due to methodological concerns about the matched-pairs research design. Financial data were from published accounting statements in BET and Hungarian Business Information database. In my sample the businesses were classified into those following IFRS and those following domestic accounting rules. For the IFRS adopting enterprises the adoption year was treated as event year 0. To analyze enterprises' adoption decision, I required data on stock returns, accounting earnings, total assets, market capitalization, leverage, growth, foreign sales, and sales per employee one year prior to event year 0, and closely held shares for event year 0. Close_Held is measured in event year 0.

The adoption decision models were expanded following research by Nobes (2006), and it was tested if the demand from internal performance evaluations was a factor in businesses' decisions to adopt international accounting standards.

We arrived at the following logistic regression model (1) using prior literature (Wu and Zhang, 2009):

$$\begin{aligned} Prob[Adopt = 1] = Logit\,(&a_0 + a_1\,Close\_Held_0 + a_2\,Labor\_Prod_{-1} \\ &+ a_3\,ROE_{-1} + a_4\,ROA_{-1} + a_5\,Size_{-1} + a_6\,Lev_{-1} \\ &+ a_7 Growth_{-1} + a_8 Foreign\_Sales_{-1}) \end{aligned} \tag{1}$$

where:

Close_Held is the percentage of closely held shares at the end of event year (event year of 2008 for the management turnover and employee layoffs analyses);

Labor_Prod is the labor productivity (sales per employee) minus the median labor productivity;

ROE is the return on equity;

ROA is the return on assets, accounting earnings is defined as net income before extraordinary items;

Size is the natural logarithm of market capitalization;

Lev is the leverage, defined as long-term debt divided by total assets;

Growth is the sales growth, current year's sales change divided by prior year's sales; and

Foreign Sales is the foreign sales divided by total sales.

The dependent variable *Adopt* is equal to 1 for adopting firms and 0 otherwise. All the independent variables are measured around event year 0. This model includes year and industry dummy variables.

I included lagged variables on businesses performance (ROE_{-1} and ROA_{-1}), firm size ($Size_{-1}$), leverage (Lev_{-1}), and growth ($Growth_{-1}$) on the right-hand side of the regression model and expected the coefficients on firm size, leverage, and growth to be positive. I also included foreign sales as a percentage of enterprise total sales ($Foreign\_Sales_{-1}$) and expected these variables to have positive signs.

The regression results are reported in table 7.1, which presents the logistic reports to model business decisions to adopt IFRS. In table 7.1 the coefficient estimates, standard errors, and the marginal effects are reported in columns 1–3, respectively. The $Close\_Held_0$ has a negative coefficient, –0.00445, and is significant at the 0.05 level. The marginal effect suggests that a one standard deviation increase in the percentage of closely held shares decreases the adoption likelihood by 0.64 percent.

The percentage of closely held shares can also vary with businesses' incentives to access the capital market as more closely held businesses may have lower demand for external capital. This is the reason why the research controls for various factors related to business financing needs in the regression model.

Table 7.1 **Logistic analysis of universal information methods adoption decisions**

Analysis	Estimate	Standard error	Marginal effects*
$Close\_Held_o$	–0.00445	0.0026**	–0.64%
$Labor\_Prod_{-1}$	–0.00005	0.0003 **	–1.08%
ROE_{-1}	–0.1134	0.1447	–0.30%
ROA_{-1}	–0.5609	0.7148	–0.31%
$Size_{-1}$	0.2659	0.0461***	4.21%
Lev_{-1}	1.3004	0.4882***	1.12%
$Growth_{-1}$	–0.2883	0.2021	–0.50%
$Foreign\_ Sales_{-1}$	1.2085	0.2301***	3.08%

*Marginal effects measure the changes in the predicted probability from a one standard deviation increase from the mean for a continuous variable and from 0 to 1 for an indicator variable with the other variables measured at the mean.
,* Indicate that a coefficient is significantly different from zero at the 10 percent and 5 percent levels, respectively (one-sided tests for coefficients with predictions and two-sided tests for those without a prediction).

Source: Author's own construction.

The coefficient on *Labor_Prod*$_{-1}$ is –0.00005, negative as expected and significant at the 0.05 level. The marginal effect indicates that a one standard deviation increase in labor productivity reduces the likelihood of adoption by 1.08 percent. Regression has reasonable predictive power with a Pseudo R^2 of 32 percentages.

I analyzed CEO turnover-to-performance sensitivities separately for the adopting standards and the domestic rules samples using model (2):

$$\begin{aligned} Prob[CEO\_Turnover_t = 1] = Logit(&a_0 + a_1 DROA_{t-1} + a_2 DRET_{t-1} \\ &+ a_3 Post + a^4 Post * DROA_{t-1} \\ &+ a_5 Post * DRET_{t-1} \\ &+ \textstyle\sum b_j Control\ variable_j) \end{aligned} \tag{2}$$

where:

CEO_Turnover = 1 if there is a CEO turnover in event year t and 0 otherwise;

DROA = 1 if ROA of event year *t*–1 is negative and 0 otherwise;

DROE = 1 if annual owner's equity return of event year *t*–1 is less than 20 percent and 0 otherwise; and

Post = 1 if a firm-year observation is post-event year 0, and 0 for pre-event year 0 observations (event year 0 itself is removed).

The dependent variable, *CEO_Turnover*$_t$, is an indicator equal to 1 if there is a CEO turnover in year *t* and 0 otherwise. Post is an indicator variable equal to 1 if the firm-year is post-event year 0 and 0 otherwise (event year 0 itself is removed from the analysis). The study includes the explanatory variables from the earlier adoption decision regression (except for ROA and ROE) to control for business incentives to adopt international accounting standards and their potential impact on CEO turnover. These variables

Table 7.2 **CEO turnover-to-performance sensitivity analysis**

Analysis	**Standards adopting enterprises**		**Domestic rules using enterprises**	
	Estimate	**Standard error**	**Estimate**	**Standard error**
$DROA_{t-1}$	–0.2611	0.2469	0.2249	0.2055
$DROE_{t-1}$	0.0221	0.2449	0.3002**	0.0522
$Post_t$	–0.0415	0.1456	0.0110	0.0928
$Post_t{*}DROA_{t-1}$	0.8062***	0.3092	–0.0175	0.2473
$Post_t{*}DROE_{t-1}$	0.0810	0.1960	–0.0708	0.1961
$Close\_Held_t$	0.0007	0.1965	0.0026	0.1935
$Labor\_Prod_{t-1}$	–0.0001	0.0002	0.0001	0.0001
$Size_{t-1}$	0.0857**	0.0406	0.0391	0.0345
Lev_{t-1}	–0.5109	0.5521	0.0282	0.3062
$Growth_{t-1}$	–0.2152	0.4063	–0.4028*	0.2749
$Foreign\_\ Sales_{\ t-1}$	–0.2949	0.2092	–0.0234	0.1710

*, **, *** Indicate that a coefficient is significantly different from zero at the 10 percent, 5 percent, and 1 percent levels, respectively (one-sided tests for coefficients with predictions and two-sided tests for those without a prediction).

Source: Author's own construction.

are measured around year *t*. The results for model (2) are reported in table 7.2.

I expected a positive coefficient on $Post{*}DROA_{t-1}$ for the adopting sample and negative for local accounting rules businesses.

The insignificant coefficient on $Post{*}DROE_{t-1}$ is inconsistent with an overall increase in the performance sensitivities of CEO turnover at the adopting firms that might result from concurrent organizational changes other than accounting changes.

The next model (3) is an analysis of layoff-to-performance sensitivities separately for the adopting standards and local rules samples.

$$\begin{aligned} Prob[Layoff_t = 1] = \; & Logit\ (a_0 + a_1 DROA_{t-1} + a_2 DRET_{t-1} \\ & + a_3 Post + a_4 Post * DROA_{t-1} \\ & + a_5 Post * DRET_{t-1} + \sum b_j\, Control\, variable_j \quad (3) \end{aligned}$$

The dependent variable, *Layoff*$_t$, is an indicator equal to 1 if there is a reduction of a business employee headcount of more than 5 percent in year *t*, and 0 otherwise. The explanatory variables on the right-hand side are the same as those in model (2) on management turnover, except for the addition of several control variables. Since the change in employee headcount can reflect contemporaneous changes in a business's overall scale of operations, the study includes sales growth (*Growth*), change in foreign sales (Δ*Foreign_Sales*), and an indicator variable for fixed assets disposal (*Fix_Disposal*) for year *t*.

The results for model (3) are reported in table 7.3.

UNIVERSAL ACCOUNTING METHODS AND COMPANY PERFORMANCE EFFECTS

This set of analyses measures how Hungarian enterprises have been affected on management performance by IFRS. The logistic regression models employed are as follows (4 and 5):

$$\begin{aligned} RR_{i,t} = \; & a_0 + a_1 Size_{i,t} + a_2 Dividend_{i,t} + a_3 Growth_{i,t} \\ & + a_4 Profitability_{i,t} + a_5 Liquidity_{i,t} + a_6 Leverage_{i,t} + e_{i,t} \quad (4) \end{aligned}$$

Table 7.3 **Employee layoff-to-performance sensitivity analysis**

	Standards adopting enterprises		Domestic rules using enterprises	
Analysis	**Estimate**	**Standard error**	**Estimate**	**Standard error**
$DROA_{t-1}$	0.2805*	0.1838	0.5126***	0.0844
$DROE_{t-1}$	0.2016**	0.1050	0.1885**	0.0592
$Post_t$	0.0269	0.1162	0.0386	0.0432
$Post_t{*}DROA_{t-1}$	0.5345**	0.2628	0.0034	0.0973
$Post_t{*}DROE_{t-1}$	0.1968	0.1403	0.0783	0.0682
$Close\_Held_t$	0.0033*	0.1985	0.0009	0.0765
$Labor\_Prod_{t-1}$	–0.0006	0.0004	–0.0001**	0.0001
$Size_{t-1}$	–0.0177	0.0289	–0.0274**	0.0131
Lev_{t-1}	0.3978	0.3831	0.3193**	0.1353
$Growth_{t-1}$	–0.1266	0.2115	–0.3034***	0.0863
$Foreign\_Sales_{t-1}$	–0.0563	0.1546	0.0354	0.0630
$\Delta Foreign\_Sales_t$	–0.2631	0.6219	–0.3361	0.2683

(*Source*: Author's own construction)

* The estimation results.

,* Indicate that a coefficient is significantly different from zero at the 10 percent and 5 percent levels, respectively (one-sided tests for coefficients with predictions and two-sided tests for those without a prediction).

Source: Author's own construction.

$$PA_{i,t} = a_0 + a_1 Size_{i,t} + a_2 Dividend_{i,t} + a_3 Growth_{i,t} + a_4 Profitability_{i,t} + a_5 Liquidity_{i,t} + a_6 Leverage_{i,t} + e_{i,t} \quad (5)$$

where:

$RR_{i,t}$ = dummy variable, indicating the regulatory system;
$RR_{i,t}$ = 1, financial numbers are reported under IFRS;
$RR_{i,t}$ = 0, financial numbers are reported under Domestic GAAP;
$PA_{i,t}$ = dummy variable, indicating the postadoption effects;

$PA_{i,t}$ = 1, financial numbers are reported under IFRS in 2007;

$PA_{i,t}$ = 0, financial numbers are reported under IFRS in 2006;

Size = natural logarithm of market capitalization

- *NAVSH*: net asset value per share;
- *RESSFU*: reserves to shareholders' funds;

Dividend:

- *DIVCOV*: dividend cover;
- *DIVSH*: dividend per share;
- *DIVYI*: dividend yield.

Growth:

- *MVBV*: market value to book value;

Profitability:

- *EPS*: earnings per share;
- *NPM*: net profit margin;
- *ROCE*: return on capital employed;

Liquidity:

- *CFM*: cash flow margin;
- *CUR*: current ratio;
- *OCF*: operating cash flow scaled by total assets;
- *QUI*: quick ratio;
- *WCR*: working capital ratio;

Leverage:

- *DEBTE*: debt to equity;
- *DSFU*: debt to shareholders' funds;
- *CGEAR*: capital gearing;

$e_{i,t}$ = the error term.

The results are reported in table 7.4.

Table 7.4 **Company performance effects**

	Domestic GAAP employed enterprises		**IFRS adopted enterprises**	
Denomination	**Mean**	**Std. deviation**	**Mean**	**Std. deviation**
DIVSH	0.0846	0.1986	0.1557	0.2106
DIVYI	17.5764	19.8721	22.8705	25.4457
MVBV	5.8152	7.8125	2.5478	8.1547
NPM	–0.2945	4.5412	–0.1031	7.4581
EPS	0.1987	1.0561	0.1897	1.5061
ROCE	0.2008	0.3051	–0.0081	0.6401
OCF	3.8812	15.4421	4.8512	16.8041
CUR	1.9911	6.9105	2.9814	3.1125
CFM	0.8029	2.3126	–0.0408	1.5974
DEBTE	1.9843	2.3566	2.3099	2.1577
CGEAR	0.3454	0.2325	0.8714	0.3115
DSFU	0.3258	0.1353	0.5469	0.8540

Source: Author's own constructions.

It is provable by table 7.4 that the average index of dividend per share (coming from earnings after tax) is more prosperous for companies that have already adopted the IFRS than in those who have not. However, the relative average value (DIVYI) contains a high deviation (the deviation value is almost 30 in case of companies operating with IFRS).

The companies applying the national accounting standards are gaining more than double (5.8152) in terms of growth, measured by market value of assets to historical value of assets, with respect to other enterprises. In this sense the IFRS user companies' average index is much lower.

The monitored enterprises had a negative average net profit value (loss) in both group in the covered period. However the return on equity and the average return on capital employed give better results in case of national accounting standards users. The latter index showed a declining tendency (–0.0081) for companies that adopted the IFRS.

The examined domestic accounting standard user companies' average indexes, measuring solvency (OCF, CUR, CFM), and leverage were more prosperous than that of the others. The cash flow, for instance, decreased (–0.0408) for IFRS user companies, though around the relative average value of operating cash flow on assets the deviation is quite high (it is between 15 and 17). As the indebtedness of companies accounting according to domestic regulation was lower, the leverage indexes (DEBTE, CGEAR, DSFU) were better than the other companies that adopted IFRS.

To sum up, it can be stated that the management performance indexes deteriorated especially regarding solvency and prosperity after IFRS was adopted in the companies that were examined.

UNIVERSAL ACCOUNTING METHODS AND EARNINGS MANAGEMENT

The first earnings management test measured the volatility of the change in net profit scaled by total assets, ΔNP, and the volatility of the change in net profit to the change in operating cash flows, ΔCF for the domestic GAAP employed and the IFRS adopted enterprises.

The second earnings management test examined the associations between accruals and cash flows. My scientific research evaluated the Pearson correlation between accruals and cash flows separately in the preofficial, official, and postofficial adoption periods. Then the author employed an Ordinary Least Square (OLS) regression, following Iatridis and Rouvolis (2010), to analyze the associations between accruals and cash flows, profitability, leverage, and size. The regression model that is used is as follows (6):

$$\begin{aligned} ACCR_{i,t} = a_0 + a_1 FRS_{i,t} + a_2 FRSOCF_{i,t} \\ + a_3 FRSLNMV_{i,t} + a_4 FRSOPM_{i,t} \\ + a_5 FRSTLSFU_{i,t} + e_{i,t} \end{aligned} \quad (6)$$

where:

$ACCR_{i,t}$ = accruals scaled by total assets;
$FRS_{i,t}$ = dummy variable indicating the financial reporting system in use;
$FRS_{i,t}$ = 1 for firms reporting under IFRS in 2007;
$FRS_{i,t}$ = 0 for firms reporting under the domestic GAAP in 2006;
OCF = multiplication of IFRS and operating cash flows;
$FRSOCF_{i,t}$ = variable used to examine the impact of IFRS on the association between accruals and cash flows;
LNMV = multiplication of IFRS and the natural logarithm of market value;
$FRSLNMV_{i,t}$ = variable used to examine the impact of IFRS on the association between accruals and size;
OPM = multiplication of IFRS and operating profits margin;
$FRSOPM_{i,t}$ = variable used to examine the impact of IFRS on the association between accruals and profitability;
TLSFU = multiplication of IFRS and total liabilities to shareholders' funds.
$FRSTLSFU_{i,t}$ = variable used to examine the impact of IFRS on the association between accruals and leverage.

The results of the previous regression model (6) the author summarized in table 7.5.

According to the results of the table it can be stated that the companies that adopted IFRS reached a higher volatility in net profit value change (ΔNP) and in net profit value

Table 7.5 **Universal methods and earnings management**

Denomination	**Enterprises that followed Domestic GAAP**	**Enterprises that adopted IFRS**
Δ*NP* volatility	4.1581	6.1021
Δ*NP*/Δ*CF* volatility	11.4401	12.0120
FRSOCF	–1.21**	–0.7145**
FRSLNMV	–0.025**	–0.014*
FRSOPM	0.5541**	0.2145**
FRSTLSFU	–0.2574**	–0.1941**
R^2	0.784	0.815

* Statistical significance at 10 percent level (two-tailed).
** Statistical significance at 1 percent level (two-tailed).

Source: Author's own construction.

change/operating cash flow value change (Δ*NP*/Δ*CF*). Being so, the volatility did not decline after the standard adaptation, contrary to the companies using domestic accounting standards.

The coefficient of correlation between deferred items, namely, accrued charges and cash flow (*FRSOCF*), had a negative value in a significance level of 5 percent in both groups, even so, the leaders of the national accounting principle user companies gained higher income (–1.21).

The coefficient showing correlation between deferred items (accruals) and size of the company (*FRSLNMV*) was also negative: (–0.025) in a significance level of 10 percent and (–0.014) in a significance level of 5 percent; accordingly even the bigger companies using IAS/IFRS could not insert totally the principles of accounting accruals in their system yet.

Similarly, the companies that already adopted IFRS did not increase their accrued charges as a consequence of high indebtedness, which is showed by the coefficient of correlation between deferred items (accruals) and leverage (*FRSTLSFU*) being (–0.1941).

The coefficient of correlation between deferred items and profitability (*FRSOPM*) is significantly positive in both groups of companies. However, it is worthy of note that the companies achieving lower profitability are less willing to adapt accrual principles into their accounting policy.

As a conclusion, it is my conviction that the practical results, for instance, in case of *FRSOCF*, have proven my assumption that the income level of concerned leaders of companies that adopted the IFRS is decreased in a significance level of 5 percent.

UNIVERSAL ACCOUNTING METHODS AND P&L EFFECTS

This part of our research examined whether firms determine small positive profits rather than large losses. Our analysis employed the next model (7):

$$\begin{aligned} RR_{i,t} = a_0 + a_1 Profitability_{i,t} + a_2 Dividend_{i,t} \\ + a_3 Growth_{i,t} + a_4 Size_{i,t} + a_5 Liquidity_{i,t} \\ + a_6 Leverage_{i,t} + a_7 SP_{i,t} + a_8 LL_{i,t} + e_{i,\mathrm{t}} \end{aligned} \tag{7}$$

where:

$SP_{i,t}$ = dummy variable indicating a measure of small positive profits;

$SP_{i,t}$ = 1 if net profit scaled by total assets is between 0 and 0.01;

$SP_{i,t}$ = 0 otherwise;

$LL_{i,}$ = dummy variable indicating a measure of timely loss recognition;

$LL_{i,t}$ = 1 if net profit scaled by total assets is less than –0.20;

$LL_{i,t}$ = 0 otherwise.

UNIVERSAL ACCOUNTING METHODS AND VALUE RELEVANCE

The first value relevance test is an OLS regression of share price on book value per share and net profit per share (8).

$$P_{i,t} = a_0 + a_1 BVPS_{i,t} + a_2 NPPS_{i,t} + e_{i,t} \tag{8}$$

where:

$P_{i,t}$ = total market value of equity deflated by number of shares outstanding;
$BVPS_{i,t}$ = total book value of equity deflated by number of shares outstanding;
$NPPS_{i,t}$ = total net profit deflated by number of shares outstanding.

The second value relevance test is an OLS regression of profits on stock returns (9).

$$NPP_{i,t} = a_0 + a_1 AR_{i,t} + e_{i,t} \tag{9}$$

where:

$NPP_{i,t}$ = net profit divided by beginning of year share price;
$AR_{i,t}$ = annual stock return at year-end.

The third value relevance test measured the association between IFRS-based book value and net profit figures, then stock returns (10).

$$\begin{aligned} AR_{i,t} = a_0 + a_1 BVPS_{i,t} + a_2 BVCHA_{i,t} \\ + a_3 NPPS_{i,t} + a_4 NPCHA_{i,t} + e_{i,t} \end{aligned} \tag{10}$$

where:

$BVCHA_{i,t}$ = variable indicating the change in corporate book value following the transition to IFRS;

Table 7.6 **Universal method effects**

	Domestic GAAP-using firms		**IFRS-using firms**	
Denomination	**Mean**	**Std. deviation**	**Mean**	**Std. deviation**
DIVSH	0.0846	0.1986	0.1557	0.2106
DIVYI	17.5764	19.8721	22.8705	25.4457
MVBV	5.8152	7.8125	2.5478	8.1547
NPM	–0.2945	4.5412	–0.1031	7.4581
EPS	0.1987	1.0561	0.1897	1.5061
ROCE	0.2008	0.3051	–0.0081	0.6401
OCF	3.8812	15.4421	4.8512	16.8041
CUR	1.9911	6.9105	2.9814	3.1125
CFM	0.8029	2.3126	–0.0408	1.5974
DEBTE	1.9843	2.3566	2.3099	2.1577
CGEAR	0.3454	0.2325	0.8714	0.3115
DSFU	0.3258	0.1353	0.5469	0.8540

Source: Author's own constructions.

$NPCHA_{i,t}$ = variable indicating the change in corporate net profits following the transition to IFRS.

The results of hypotheses H_1 are reported in table 7.6.

It can be seen in table 7.6 that the average index of dividend per share (from earnings after tax) is higher for companies that had already adopted IFRS than in others. However, the relative average value (*DIVYI*) contains a high deviation (the deviation value is almost 30 in respect of companies using IFRS).

The companies applying the Domestic Accounting Rules earn more than double (5.8152) in terms of growth (measured by market value to historical value of assets) than do other firms. In this sense the IFRS-adopting companies' average index is much lower.

The companies examined had a negative average net profit value (loss) in both groups in the period covered, although the return on equity and the average return on capital employed gave better results for domestic accounting rules users. The latter index showed a declining tendency (–0.0081) for companies that adopted the IFRS.

The average indices measuring solvency (OCF, CUR, CFM) and leverage for companies using domestic accounting rules were higher than for others. Cash flow, for instance, decreased (–0.0408) for IFRS-using companies, although around the relative average value of operating cash flow on assets the deviation is quite high (between 15 and 17). As the indebtedness of companies using domestic regulations was lower, the leverage indices (DEBTE, CGEAR, DSFU) were better than in those companies that had adopted IFRS.

To summarize, we can state that balance sheet indexes deteriorated especially regarding solvency and prosperity after the adoption of IFRS.

The results of model (3) are reported in table 7.7.

The data in table 7.7 prove that the companies that had already adopted IFRS were less willing to hide profit in the P&L account when it was low, and by doing so, the probability of reporting a small profit (SP) was significantly negative (–1.194) in their case.

Further, we can state that neither did they tend to hide a large loss. The latter statement is a consequence of the positive and high value of the coefficient of LL (2.581). It

Table 7.7 **Small profit or large losses**

Denomination	IFRS-adopting firms	Domestic GAAP-using firms
SP	–1.194**	0.451
LL	2.581*	1.324

* At 10 percent level significance.

** At 5 percent level significance.

Source: Author's own constructions.

is specific for companies using national accounting rules to favor reporting smaller profits (0.451) and avoid large losses being reported in P&L Account, which is possible when using accrual-based accounting.

The results of value relevance models are summarized in table 7.8.

Our H_3 assumption, namely, that the information system of companies who adapted IFRS shows a higher value relevance than other companies using national accounting rules, is proved by the data of table 7.8.

The first test of value relevance gave a result for earnings after tax/share (EPS) coefficient (3.025) and for book value of equity/share (1.354), which is significantly (at 1 percent) positive and higher at IFRS-adopting companies than at others. These companies also had more profitable, higher correlation coefficients of financial indices (R^2 = 0.799).

The second test of value relevance gave similar results since the coefficient of return on equity (ROE) is also significantly

Table 7.8 **Universal methods and value relevance**

Denomination	**Coefficients**	
	Domestic GAAP-using firms	**IFRS-using firms**
NPPS	2.041**	3.025**
BVPS	0.547**	1.354**
AR	2841.145**	3694.124*
BVCHA	0.1941**	0.2941*
NPCHA	0.0182**	1.3541
R^2	0.689	0.799

* Statistical significance at 10 percent level.

** Statistical significance at 1 percent level.

Source: Author's own construction.

positive (at 10 percent) and higher (3694.124) for companies that have already adopted IFRS.

The coefficient of book value change (1.3541) produced turned out significantly more positive for IFRS-adopting companies according to the third test of value relevance. These results obviously prove that the companies that adopted IFRS have an orientation toward a reporting policy based on greater reliability and more realistic evaluation. However, the index presenting the change of net profit (NPCHA) was also positive (but not significantly so) for these companies (1.3541).

EMPIRICAL RESULTS

The results showed that businesses with lower labor productivity compared to their industry peers have greater incentives to adopt international accounting standards. As hypothesis 1 predicted, businesses face a better need for informative measures of enterprises performance to facilitate internal performance evaluation, therefore a higher probability of international standards. It was expected that the coefficients on the percentage of closely held shares ($Close\_Held_0$) and labor productivity (industry-adjusted sales per employee; $Labor\_Prod^{-1}$) variables to be negative, because prior research suggested that these variables associated with disclosure incentives have predictive power for the adoption decision (e.g., Whittington, 2008; Schleifer and Vishny, 2003). The control variables signed that larger businesses, those with higher leverage, with more substantial foreign sales are more likely to adopt international standards. I found that *Close_Held* are consistent with compensation contracting demands affecting business decisions to adopt international accounting standards.

The marginal effect suggests that a one standard deviation increase in the percentage of closely held shares decreases the adoption likelihood by 1.25 percent, or 5 percent of unconditional adoption probability of 20 percent (65/325). This supports a greater demand for more informative and conservative accounting earnings due to management performance evaluations more widely held by businesses stimulating to adopt international accounting standards.

Hypothesis 2 certified that the sensitivity of CEO turnover to accounting earnings increased after the adoption of international accounting standards, because both earnings and stock returns affected management turnover. In my management turnover test the indicator variable *DROA* equals 1 and the stock return 17 percent (below 20 percent). But the accounting earnings are timelier, less managed, and more conservative after the adoption of international accounting standards. Also they are more effective tools for internal performance evaluations and governance of businesses as I found in my research too.

The study showed that both business earnings and stock returns affect the management turnover. Controlling for the effects of macro-economic conditions and employee layoffs by including the market return in Hungary it was pointed out that the coefficients on market returns had been insignificant in the various regressions. Analyzing the changes in labor productivity at the adopting businesses the tests did not show a significant decreasing in the productivity over the last five years. It could be that businesses' labor productivity is persistently low, not necessarily deteriorating continuously, in the several years leading up to the adoption. Meanwhile, there is a significant increase in labor productivity over event years.

I measured earnings and stock performances with indicator variables of negative return on assets (ROA) and stock returns, respectively. The indicators with continuous measures of ROA and stock returns were replaced. The inferences on employee layoffs are unaffected. However, the results on turnover are sensitive to this change in variable specification. This suggests that the increase in the sensitivity of turnover to accounting performance postadoption is primarily driven by heightened turnover sensitivity to accounting losses. The prior studies suggested that variables associated with disclosure incentives have predictive power for the adoption decision and showed that both earnings and stock returns affect management turnover (see, e.g., Easton, 2006).

Hypothesis 3 is certified in my tests that the employee layoff sensitivity to poor accounting performance increased after the adoption of international accounting standards. The adopting firms' employee layoffs are more response to accounting performance postadoption. With respect to the control variables, the study founded that businesses with higher labor productivity, which are larger, with greater contemporaneous and lagged sales growth, have less frequent layoffs. On the other hand, businesses with higher leverage and with divestitures have more frequent employee layoffs. Continental European countries are known for their strong employment protection laws and powerful labor unions (Zeff, 2006).

DISCUSSIONS

Enhanced Disclosure of Fair Value Measurement

Criticism was leveled at the International Accounting Standards Board (IASB) because many stakeholders felt that insufficient disclosure was provided on various components of fair value measurement, including the sensitivities of inputs in the determination of the fair value and the effect of fair value measurements on profit and loss. The IASB has recently released amendments to the existing IFRS 7: Financial Instruments: Disclosures. These amended disclosures are required for entities with financial reporting periods commencing on or after January 1, 2009, and are based on the US general accepted accounting principles (US GAAP) standard, FAS 157, Fair Value Measurements.

Reclassification of Financial Instruments

The IASB was subject to an enormous amount of political pressure with the European Union (EU) threatening to withdraw its endorsement of IFRS if it did not permit the reclassification of certain financial instruments. Previously, the EU had required all EU publicly listed entities to adopt IFRS for reporting periods commencing on or after January 1, 2005.

In an unprecedented step, the IASB, without due process being followed, in October 2008, released an amendment to the existing standard allowing for the reclassification of financial assets previously carried at fair value to be carried at amortized cost, depending on various circumstances. This not only allowed entities to reverse previously recognized losses, but also allowed these instruments to be carried now at amortized cost. The amount of disclosure required for the reclassification is fairly onerous.

Off-Balance Sheet Structures and Derecognition

Standard setters have been criticized as to the reasons why accounting standards allowed for certain transactions to be derecognized from the balance sheet and for allowing special purpose vehicles, created by a group, not to be consolidated.

The existing accounting treatment of the consolidation of special purpose vehicles, including securitization vehicles, when evaluated against the current accounting requirements may not have required such vehicles to be consolidated in the groups' financial statements. The reason for the nonconsolidation of these vehicles was that the focus for the evaluation of control was on the legal obligations of the creator of the vehicle, with constructive obligations largely ignored.

This has resulted in loan obligations, related financial assets, and profits or losses in these vehicles not being included in the financial results of the group. However, when these vehicles went into default, the group took ultimate responsibility for making good losses to investors and thereby, through their actions, acknowledged that they had indeed controlled these vehicles. In evaluating whether or not control existed, a legalistic approach was followed; this resulted in constructive obligations being ignored in concluding whether or not these vehicles should be included in the group financial statements.

The US standards are currently more rule based in comparison to the IFRS. Studies have shown that if entities currently applying US GAAP had applied the provisions contained in IFRS rather than that of US GAAP, it would have drastically increased the number of special purpose vehicles requiring consolidation. An exposure draft was released by the IASB in December 2008, which proposed that a control model should be applied when assessing whether a special purpose vehicle should be consolidated. Other requirements include the continual reassessment of whether or not an entity controls another entity, including the potential consolidation of entities where the consolidating entity does not hold a majority interest. Nonconsolidation of an entity requires onerous disclosures.

With regard to recognition of financial instruments, current standards written by the IASB and the FASB contain a complex set of rules against which entities have to evaluate specific transactions, in order to derecognize financial instruments off their balance sheet. The US standard contains more rules for derecognition when compared to those contained in IFRSs. In the development of accounting standards, the IASB has always attempted to develop principle-based standards.

Measurement of Own Credit in Financial Liabilities

Due to the existing stringent requirements contained in IAS 39, Financial Instruments: Recognition and Measurement for the hedging of financial instruments, many entities have been unable to apply hedge accounting due to incompatible policies and procedures. This has resulted in many entities applying the fair value option (FVO) to fixed rate financial liabilities in cases where interest rate derivatives are used to hedge interest rate risk.

The FVO requires entities to measure the full fair value of the liability, including the impact of own credit, when applying the fair value option. This has led to the ludicrous situation where an entity would recognize a profit on the deterioration of its credit rating. This is contradictory to the economic reality, as the deterioration in an entity's credit rating indicates that the entity is not performing well and should by no means recognize a profit on the deterioration of its own credit.

An exposure draft was issued in June 2009 on how an entity's own credit should be included in the determination of the fair value of financial liabilities.

Measurement and Classification of Financial Instruments

The existing standards on financial instruments stretch over 750 pages in the Bound Volume of IFRS, and contain a combination of rules and principles that make it difficult to comprehend. The current version of IAS 39 includes four different categories of financial assets, two categories of financial liabilities, and a further option for entities to designate financial instruments at fair value through profit and loss, if certain criteria are met.

The approach likely to be followed by the IASB is to mirror the principles contained in the IFRS for small and medium entities (SMEs), which contains a more simple approach to the classification of financial instruments. This approach includes only two categories of financial instruments: those that are categorized at fair value and those measured at amortized cost. The IFRS for SMEs would be supplemented by the business overlay model when evaluating the appropriate classification of financial instruments.

The exposure draft states that financial instruments with the profile of interest-yielding instruments may be measured at fair value, and with all other financial instruments recognized at fair value, and with changes recognized through the income statement. Changes in fair value can only be recognized in other comprehensive income (OCI) for equity instruments that an entity holds for strategic business purposes. There will be no recycling of amounts recognized in OCI with regard to these instruments.

Impairment Provisioning

There is a great debate about whether or not the current accounting standards model for determining impairments is appropriate. Various European central banks have recommended different models that would allow entities to effectively spread impairment losses over the periods of prosperity. Alternatively, the Bank of Spain, which was the least affected European financial system during the crisis, has recommended the use of a complicated mathematical equation for the determination of impairment provisions.

Further questions surrounding this issue include whether the "incurred loss method" of recognizing impairment or the Basel II method of "expected losses" is the correct method of recognizing impairment. An exposure draft relating to impairments is expected to be released in September 2009.

Hedge Accounting

Current provisions to apply hedge accounting are extremely onerous. Many simple transactions such as the hedging of simple inventory transactions or capital assets are disallowed, or are prohibitively too expensive to be implemented. The IASB has committed to reevaluating the provisions of hedge accounting, which would hopefully ease the ability of entities to apply hedge accounting. An exposure draft on this is expected toward the end of 2013.

This study examines the impact of the adoption of international accounting standards on the financial performance of businesses listed on the Budapest Stock Exchange in Hungary. The research work also seeks to identify the financial attributes of enterprises that follow domestic rules employed by the requirements of the Hungarian Financial Ministry.

The purpose of this study was measuring the differences between the domestic rules and the international methods and evaluating and analyzing their effects on the business decisions. This survey contains information on how universal information methods functioned during the global financial crisis.

8. International Accounting Standardization Process

Standardization is the process of developing and agreeing upon technical standards. The standard is a document that establishes uniform engineering or technical specifications, criteria, methods, processes, or practices. Some standards are mandatory while others are voluntary. Voluntary standards are available if one chooses to use them. Some are de facto standards, meaning a norm or requirement that has an informal but dominant status, whereas others are de jure, meaning formal legal requirements. Formal standards organizations such as the International Organization for Standardization or the American National Standards Institute are independent of the manufacturers of the goods for which they publish standards.

In social sciences, including economics, the idea of standardization is close to the solution for a coordination problem, a situation in which all parties can realize mutual gains, but only by making mutually consistent decisions. Standardization implies the elimination of alternatives in accounting for economic transactions and other events. Harmonization refers to reduction of alternatives while retaining a high degree of flexibility in accounting practices, and it allows different countries to have different standards as long as the they do not conflict.

For example, within the European Union harmonization program, if appropriate disclosures are made, companies are

J. Beke, *International Accounting Harmonization*

permitted to use different measurement methods: for valuing assets, German companies could use historical cost, while Dutch businesses could use replacement costs without violating the harmonization requirements.

BASIC FEATURES AND METHODS OF THE EMPIRICAL RESEARCH

This chapter aims to provide an overview of the outcomes of the surveys on Hungarian practice, with particular focus on the impact of international financial reporting standards on the operations and financial performance of enterprises. The base population includes public and private limited companies with a headcount of over 50 and premises in Hungary. Out of the 1,097 companies that fit this definition, 248 were included in the sample, 35 of which are listed in the Budapest Stock Exchange. The latter sample size should be judged in light of the fact that throughout the period under review (2010–12), the number of listed companies remained below 60. The enterprises following the Hungarian rules of accounting were selected by simple random sampling. The scope of our examination thus includes approximately a quarter of the sample (22.6 percent).

Table 8.1 shows the companies in the sample by industry. They do not include financial enterprises, insurers, and brokerage firms in this research, as their accounting information systems are more difficult to compare with those of traditional industries.

This is borne out by the fact that specific accounting regulations for such enterprises are provided for in government decrees related to Act on Accountancy. It obtained financial and accounting data from the database of the Budapest Stock Exchange, domestic business information system, and Electronic Company Registration of the Ministry of Public Administration and Justice. Information on the entire

Table 8.1 **Companies in the sample by industry and type of accounts**

	Type of accounts	
Industry	**Domestic regulations**	**IFRS-based**
Agriculture	59	0
Manufacturing	29	15
Electricity, gas, steam, and water supply	40	3
Trade and repair	47	4
Accommodation and food services	23	2
Transportation, storage, post, and telecommunications	15	4
Financial services	0	2
Real estate activities, economic services	0	5
Total	*213*	*35*

Source: Own calculations.

population was provided by the Dissemination Database of the Hungarian Central Statistical Office.

Table 8.2 clearly indicates that the sample is not representative for industries. Although it was not the purpose of the research but it is important to note this for the sake of completeness and to avoid any possible misunderstanding.

The empirical analyses based on financial information were disclosed in accounting reports for the business years 2010–12. An examination of the 2012 business period deserves particular attention also because Recital 17 of Regulation (EC) No 1606/2002 held it necessary for the EU member states to defer the application of certain provisions until 2012 for those companies publicly traded both in the community and on a regulated third-country market as were already applying another set of internationally accepted standards as the primary basis for their consolidated accounts.

Table 8.2 **Companies in the sample and the entire population by industry**

Industries	**Number (percentage) of companies in the sample**	**Number (percentage) of public and private limited companies with a headcount of over 50 and premises**
Agriculture	59 (23.8)	179 (15.8)
Manufacturing	44 (17.7)	358 (32.6)
Electricity, gas, steam, and water supply	43 (17.4)	62 (5.7)
Trade and repair	51 (20.6)	169 (15.4)
Accommodation and food services	25 (10.1)	28 (2.6)
Transportation, storage, post, and telecommunications	19 (7.7)	82 (7.5)
Financial services	2 (0.8)	82 (7.5)
Real estate activities, economic services	5 (2.0)	143 (13.0)
Total	*213*	*1,097*

Note: Data for 2012.

Source: Author's own editing based on sample data and the Dissemination Database of the Hungarian Central Statistical Office.

Companies that had only publicly traded debt securities would also be exempt. It was nonetheless held crucial that by 2012 at the latest a single set of global international accounting standards, the IAS, be applied to all community companies publicly traded on a community-regulated market. Another reason for not taking into account data on subsequent business years for the purpose of this research is that the global financial crisis would have prevented comparable results from being obtained. The author used IBM SPSS Statistics 19 for financial analysis.

FINDINGS AND EVALUATION

At the beginning of this empirical study, the author carried out a comparative analysis for any significant difference between the economic performance of companies already applying international standards and of those following domestic rules of accounting. The economic performance of the companies under review was compared against 16 financial indicators for the period between 2010 and 2012 (see table 8.3).

In addition to the average of the financial indicators, table 8.4 includes their standard deviations and the values

Table 8.3 **Description of the indicators used for this study**

Indicators	**Calculation**
Sales to earnings after taxation	Earnings after taxation/net sales
Sales to total assets	Net sales/total assets
Sales to operating profit	Operating profit/net sales
Net change in sales since 2011	Net sales (2012)/net sales (2011)
Net change in sales since 2010	Net sales (2012)/net sales (2010)
Assets to equity	Total assets/owner's equity
Liquidity	Current assets/liabilities
Working capital ratio	(Current assets-liabilities)/total assets
Leverage	Liabilities/owner's equity
Return on equity (ROE)	Earnings after taxation/owner's equity
Return on assets (ROA)	Earnings after taxation/total assets
Capital to total assets	Registered capital/total assets
Capital to equity	Registered capital/owner's equity
Increase in capital	Owner's equity/registered capital
Change in net assets (previous year = 100%)	Total assets (2012)/total assets (2011)
Change in net assets (2010 = 100%)	Total assets (2012)/total assets (2010)

Source: Author's own construction.

Table 8.4 **Results describing the indicators under review, compared by the type of accounts**

Indicators	Enterprises preparing accounts under domestic regulations				Enterprises preparing accounts according to IFRS			
	Median	Mean	Standard deviation	Skewness	Median	Mean	Standard deviation	Skewness
Net sales to earnings after taxation	0.02	0.11	0.47	9.62	0.06	–0.57	3.95	–5.89
Net sales to assets	1.06	1.35	1.11	2.40	0.93	1.35	1.89	3.49
Sales to operating profit	0.03	0.14	0.69	8.59	0.06	–0.58	4.07	–5.89
Changes in sales (previous year = 1)	1.06	1.19	1.93	14.29	1.06	1.28	0.74	3.24
Changes in sales (2005 = 1)	1.14	1.95	8.88	12.87	1.23	1.76	1.82	3.27
Changes in assets to equity	1.79	2.49	2.25	3.68	1.61	2.11	1.26	2.21
Liquidity	1.05	1.23	0.97	2.31	1.35	2.46	4.59	5.00

Working capital ratio	0.02	–0.05*	0.51	–7.53	0.10	0.09*	0.33	–0.27
Leverage	0.67	1.38	2.16	3.76	0.60	1.07	1.21	2.13
Return on equity (ROE)	0.05*	0.19	0.67	6.23	0.11*	0.19	0.53	5.45
Return on assets (ROA)	0.02*	0.15	0.60	6.19	0.05*	0.07	0.10	1.71
Capital to assets	0.24*	0.30	0.48	9.01	0.18*	0.25	0.26	1.69
Capital to equity	0.49	0.49	0.31	1.29	0.28	0.55	1.04	5.11
Increase in capital (previous year = 1)	2.02	4.45	7.03	4.72	3.59	6.16	6.67	1.85
Changes in assets (previous year =1)	1.04	1.15*	1.24	13.84	1.09	1.31*	0.54	1.78
Changes in assets (2010 = 1)	1.11*	1.60	5.25	13.56	1.18*	1.52	0.94	1.95

Note: *With both mean and median, significance (*p*) is below 5 percent for hypothesis testing to compare the value of the two groups.

Source: Author's own calculations.

of the skew indicator. The latter indicates that the distribution of the 16 financial indicators is asymmetric, showing varying degrees of skewness, that is, deviations from normal distribution. Previous researches on similar subjects published in international accounting literature (e.g., Lantto and Sahlström, 2009) have also demonstrated similar statistical characteristic in financial impact assessments of adopting the standards in practice. That is why the author also calculated the median values for the financial indicators.

The key finding based on the descriptive statistics presented in the table is that there is no statistically significant difference between the two "accounting clusters" under review (companies that adopted international accounting standards and those following domestic rules) in terms of financial ratios. Nevertheless, with a two-thirds majority of the financial indicators, the higher median values belong to companies that previously adopted the international standards. Significant differences ($p < 5$ percent) between the two accounting groups were found with only four of the indicators (e.g., return on assets, equity, capital, and changes in assets). The positive accounting conclusion offered by this may suggest that the economic and financial performance of companies adopting the international standards did not decrease following the mandatory transition in accounting methodology.

At the same time, international journals published in recent years on similar subjects by a number of authors include conclusions that the change in financial reporting (the transition from domestic regulations to accounting standards) did in fact involve a decrease in economic and financial performance, and indeed, in some countries, measures such as cutbacks affecting senior financial officers and certain employee groups (cf. Wu and Zhang, 2009). Iatridis and Rouvolis (2010), for example, report that in the case of Greek companies, the transition to IFRS led to a significant increase in the volatility of profitability indicators. Indeed, the profits of companies that had adopted international standards also suffered significantly, resulting in lower executive incomes and higher leverage, and thus poorer liquidity. This was due to the fact that increased leverage and capital costs had reduced the profitability of such firms. Lantto and Sahlström (2009) found that a positive change (significant at the 1-percent level) flowed the transition from Finnish accounting regulations to international standards with the financial indicators of sales to operating income, return on equity, and assets or leverage. However, the liquidity and market indicators of the companies deteriorated following the transition in accounting methods.

The findings of the international practices referred to in the previous paragraph also demonstrated that the impacts of the changes in accounting methodology are primarily caused by the application of rules concerning valuation (e.g., fair value rather than cost) and deferred taxation (separated application of accounting and taxation rules), by the broader or narrower interpretation of employees' benefits (particularly in the field of pensions), and by differences in procedures for the recording, amortization, and consolidation of certain asset groups (capitalization of research and development, accounting for operating, and financial leases). For instance, according to Hungarian accounting regulations, fair value measurement is a requirement only for financial instruments, historic cost being used otherwise for both financial accounts and statements. Nevertheless, the research papers referred to earlier also give accounts of the specific practices associated with the introduction of accounting standards in continental law, in countries where private undertakings played a major rule in corporate lending subject to the requirements of governments and tax authorities, such as Finland and Greece, as compared with countries following US and UK accounting principles. Research reported in international literature (e.g., Easton, 2006) has also demonstrated that the accounting practices of Anglo-Saxon countries such as Great Britain are similar to IFRS in many aspects and also have higher value relevance, as a result of which the transition from domestic regulations to standardization (the adoption of standards) has been less expensive in those countries.

In an attempt to model the business decisions of companies with Hungarian premises concerning the adoption of international accounting standards, the author used a logistic regression function. Our dependent variable is the fact of adoption (IFRS = 1, if the company has adopted the international methods; and IFRS = 0, when the company applies the domestic rules of accounting). The most efficient model used only 4 of the 16 financial indicators available or calculated. The growth of the companies under review was quantified by the dynamic changes in their sales. Liquidity was measured through the assessment of the coverage of liabilities. Finally, this model incorporated the base and chain ratios of business assets, that is, total assets (*DeltaM52*). It means that the number 52 in the balance sheet shows the net value of total assets and ε is the error term. These produced the following function:

$$\begin{aligned} IFRS_i &= \beta_0 + \beta_1 Growth07\_05_i + \beta_2 Liquidity_i \\ &\quad + \beta_3 DeltaM52\_2006_i + \beta_4 DeltaM52\_2005_i + \epsilon_i \end{aligned}$$

The author evaluated the quality of the model from three aspects. The value of significance associated with the global test of the model is virtually 0, that is, it was found an existing model. Nagelkerke's R^2, indicating the explanatory power of this model, is 0.165: this is a relatively low value compared with world-known statistical methods. The third tool to test the model fit and judge its quality is a so-called classification table (see table 8.5).

This table shows that this model has produced an overall match rate of 97.7 percent. This means that 214 companies out of 244 have been correctly classified. However, in order to judge the actual quality of the model, it is also important to take into account the match rate at line level. It seems that this model correctly classified virtually all of the companies that follow domestic accounting rules. At the same time, it could only identify and thus correctly classify 6 of the companies that adopted IFRS. This corresponds to a rate of 17.1 percent, which is relatively low. Overall, then, even the most effective model incorporating the indicators available could not capture, in good enough quality, the differences between the companies grouped by the accounting reports that they use.

Previous international studies on similar subjects produced same quality, with a fair degree of variation in the selection of sample size and methodology. For example, while explanatory power was demonstrated at 40 percent in the IFRS adoption studies by Leuz and Verrecchia (2000), the same rate was only 18 percent in La Porta (1998).

Table 8.5 **Classification table for the logistic regression model**

Observed classification	**Classification forecast**		**Ratio of correctly classified cases (%)**
	Domestic rules	**Standards**	
Domestic regulation	208	1	99.5
IFRS based	29	6	17.1
Ratio of correct classifications			*87.7*

Source: Author's own calculation.

Table 8.6 **Results for explanatory variables**

Variables	**Coefficients (B)**	**Standard error**	**Wald**	***p***	**Exp(B) (odds)**
Changes in net sales (2005 = 1)	0.133	0.059	5.073	0.024*	1.142
Liquidity	0.353	0.151	5.507	0.019*	1.424
Changes in index of net assets	3.090	0.911	11.515	0.001**	21.970
Base index of net assets	–0.825	0.263	9.848	0.002**	0.438
Constant	–4.974	0.874	32.415	0.000**	0.007

Notes: $^{*}p < 5\%$, $^{**}p < 1\%$.

Source: Author's own calculations.

Consequently, the results of this model should be evaluated with findings on quality in mind. The results for the explanatory (independent) variables of the model are presented in table 8.6.

Results of the partial tests (Wald tests) for the logistic regression model show that the value of each parameter to the variables incorporated in the model are significant. The last column of the table includes the so-called *odds*, expressing the ratio of the chances of the phenomena marked 1 (adopting international standards) and 0 (rejecting of international methods) occurring. The data in this table offer the conclusion that the greatest impact on the adoption of international standards in Hungary was made by the increase in the total assets, that is, business assets, as their increase multiplied the chances of adoption over 21-fold. A beneficial impact was also found in connection with the growth and liquidity of the companies under review, since these factors improved the chances of introducing the international methods by 14 and 42 percent, respectively. At the same time, the more than 50 percent decrease of odds in line four of the table 8.6 may be linked to early expectations for adoption results as occurring in the business years immediately following the accounting standardization process in Hungary. Experience reported in the Greek literature detailed earlier also includes such findings.

For example, in their logistic model Li and Meeks (2006) found the positive coefficient of return on assets (ROA) to have the highest odds, that is, the favorable change of this financial indicator made the greatest impact on the adoption of the standards. By contrast, Bushmann and Piotroski (2006) attributed the strongest positive impact (highest odds) to the size of the companies adopting the standards (in this model, the increase in business assets to owner's equity). It is to be noted that research by Lauz and Verrecchia (2010), referred to earlier, did not demonstrate a positive significant coefficient associated with company size. In their researches, Frankel and Li (2004) attributed the strongest positive impact (highest odds) to the capitalization of the companies (increase in owner's equity) in terms of the adoption of international accounting standards.

Ball and Lakshmann (2005) also demonstrated a positive adoption aptitude for the values of the same coefficients, although to a somewhat lesser extent. Moreover, it is worth noting the impact of an increased ratio of export sales on the increased adaptation of IFRS adoption. Among the financial impact assessments following the introduction of accounting standards, the scope of their researches included decreased productivity (sales per employee) countering IFRS adoption despite the fact that the companies concerned were far less productive than the industry average, which, in turn, provided an increasing impulse for the adoption of international methods. Nevertheless, in their final conclusions the author found that enterprises with more assets, higher leverage, and a higher ratio of exports were adopting international accounting standards at an increased rate. Additionally, negative coefficients (such as in connection with ROA and ROE indicators) increasingly called for the establishment of a financial information system that had a higher value relevance.

9. Summary and Conclusions

In today's business environment, companies need to take every opportunity they can to remain competitive. Global competition, rapid innovation, entrepreneurial competitors, and increasingly demanding customers have altered the nature of competition in the marketplace. This new competitive environment requires companies to be able to create value for their customers and to differentiate themselves from their competitors through the formulation of a clear business strategy. Business strategy must be supported by appropriate organizational factors such as an efficient manufacturing process, organizational design, and harmonized accounting information systems.

Modern business environments are increasingly competitive and dynamic. International competition through e-commerce and demand-based supply chain management dominate business. It is important for companies to develop coherent and consistent business strategies and to utilize management accounting tools to support strategic planning, decision-making, and control. To integrate business strategies with various management accounting tools, first companies need to identify the business they are in. It is essential to identify products and services, customer types, geographical markets, and delivery channels. It is useful to match the strategic business unit (SBU) with the related business unit strategy. An SBU is a company department or subsection that has a distinct external market for goods or services that differ from another SBU. A business unit strategy is about how to compete successfully in particular markets. It is important to focus on a certain segment, such as environmentally friendly cars in the automobile industry or Internet and phone banking in the retail banking industry.

The financial crisis is encouraging more critical examinations of the managerial innovations that have emerged from the audit industry, not least its pursuit of the bureaucratization of risk in the name of risk management. Coming through a crisis where risks have been real and perceived, it is increasingly seen that risk management mechanisms do relatively little to facilitate the real management of risk. Adding as they do to costs—and the income of the consultancies involved—by isolating rather than integrating the management of risk, the bureaucratic mechanisms still promoted by the audit firms and their associates provide yet further evidence of the relatively limited understanding that the audit industry has of real time management in action.

Trying to understand the crisis and reflect on its implications also illustrate the dangers of the drift away from the world of accounting practice that has been a characteristic of so much accounting research for the last few decades. Indeed at times it is possible to think that for some there has been a drift away from accounting itself: at the very least there has been a pronounced move toward studying accounting at a distance. As yet this has not been as severe in its implications as for those of our colleagues in finance research where increasing numbers have a very limited appreciation of the complexities of practice and its institutional context. There nevertheless has been a move away from analyzing just such complexities and institutional contexts in the accounting area, often in the name of theoretical elegance and methodological rigor. Interestingly this is true for both statistically based capital market studies and a great deal of more critical theorizing. Of course theoretical and methodological issues are of real importance, not least in helping to avoid methodological capture by practice norms, frameworks, and ways of looking at the world. But as numerous other social science disciplines illustrate, there are ways of balancing interests in the need for sound and reliable research with genuine interests in the complexities of practice. It really is important to understand how accounting has become implicated with the creation of new financial practices, with objectifying and simplifying the increasingly complex financial transactions that have emerged from an ever expanding investment in financial engineering. Equally significant is the need for a more informed understanding of the changes that have occurred in the influence structures in the world of accounting politics both national and international, of the changing role that accounting plays in the informational environment of organizations, and with how accounting changes in relation to shifts in the underlying nature of the socioeconomic system in which business operates.

It seems to be apparent that the appropriate international accounting information system contributes to the division of labor, to financial innovation, and to the reduction of the cost of capital and even to the increase of the businesses' earnings. The first argument for the harmonization of accounting standards is the existence of multinational companies, who invest enormous efforts into the preparation of their financial statements in order to comply with the national standards. For these companies life would be much easier if the same rules would apply to their subsidiaries all around the world. On the other hand this would be profitable for the investors as well, as they could compare the enterprises' results without difficulties, which would spare both money and other resources for them. This would also lead to the reduction of the information asymmetry between managers and investors. Information asymmetry is a costly factor, which can be blamed for the increase of the equity's cost and the inaccuracy of the economic and the financial forecasts. So the aim of international accounting standards is that similar transactions are treated the same way all around the globe, which enables the creation of unified financial statements.

The practical research was concerned with the impacts of the transition from domestic accounting rules to international universal methods. Earlier studies referred to here also found that accounting results disclosed following the adoption of international universal methods were less susceptible to influence and could be treated with greater care, and that early expectations for financial and economic performance might only be realized in business years in the future. It is on such grounds that unified business financial information systems can become increasingly effective tools as part of the management of corporate governance, as well as a means to define internal performance and to express its evaluation.

The first point addressed in the practical research was whether the economic and financial indicators of companies that had adopted the universal international methods and showed any significant differences from those of enterprises with a headcount of over 50 that prepared annual accounts but applied domestic accounting rules. The author experience with international literature, primarily in the context of the practice in Finland and Greece, was that several financial indicators of the companies concerned showed a statistically significant decrease following the universal accounting methods. However, based on the Hungarian practice, it has not been able to demonstrate any significant difference between the two "accounting clusters." Presumably, this may be due partly to the fact that the practical logistic regression model included relatively few companies that had adopted the universal accounting methods. One reason for this is that the financial and insurance sectors were not included in the analysis because of the specificities and, in several cases, differences of their accounting systems, which would have prevented comparability. The other reason is that the number of voluntary decisions concerning adoption is relatively small, as a result of which even the base population includes few enterprises applying the universal methods.

In the subsequent part of the survey, the author was able to demonstrate the financial and economic factors that could exert a statistically significant impact on the adoption of universal accounting methods. Based on the three indicators explained (sales growth, assets ratios, and liquidity), it was modeled on the adoption of international financial reporting standards and drew conclusions as to the extent of their impacts (odds). That said, practical experience convinced us that companies listed on the stock exchange had adopted the universal methods primarily in compliance with European Union regulations, adopting being a requirement for them. The impact of financial an economic factors were thus eliminated, although their role cannot be ruled out. In fact, experience from previous related international literature provides examples for relationships between the factors under review. In European and American practice, there were cases of some companies making a voluntary transition to the use of universal international methods before mandatory adoption, particularly with multinationals with premises in several countries. The latter adopted the universal accounting methods, considered as a consistent set, primarily in order to standardize and align their system of financial statements, their main goal being financial and accounting harmonization and elimination of differences between internal regulations that varied by country.

Standardization of financial accounting has tended to follow the integration of the markets employed by the accounts. The present impetus for global accounting standards follows the accelerating integration of the world economy. The global accounting standards would enable the world's stock markets to become more closely integrated. The more closely world's stock markets approach a single market, therefore, the lower should be the transaction costs for investors and the cost of capital for firms in that market. The differences in international reporting practice prior to IFRS constituted a palpable barrier to efficient international investment, monitoring, and contracting. And the literature suggests that being confined to small segmented capital markets imposes a substantially larger cost of capital on firms and transaction costs on investors, which would inhibit much worthwhile investment. Although we do not have all elements for the cost-benefit calculation, the evidence points to substantial net gains for smaller economies that have joined the IFRS regime. There is certainly empirical research evidence to support the notion that uniform financial reporting standards will increase market liquidity, decrease transaction costs for investors, lower cost of capital, and facilitate international capital formation and flow. And there is a sufficient basis to endorse IFRS and begin the challenging task of educating users, auditors, and regulators. Educators and practicing accountants have significant roles to play in this exciting future.

International accounting standards create more transparency on the financial market. This provides investors more accurate information on company profiles. This way, even small investors (and not only professionals) will be able to get the information needed for their investment choices; thus they will be able to better compete on the market. More transparency will result in more international transactions that will have reduced costs because of the clear information provided by business reports. In case of consolidated accounts (when the company has foreign subsidiaries) bookkeeping will be facilitated and will also result in reduced transaction costs. No more adjustments will be needed in order to make financial reports of companies internationally comparable. Reduced costs will also result in more cross-listings and cross-border investments. International accounting standards also have a good effect on the division of labor. These standards and thus the reduced transaction costs will enable companies to engage easily in mutual trade. This will let them specialize in the field of their strengths and rely on suppliers that are also specialists in another field of their own rather than trying to produce the same product in-house, which will create a division of labor on the market. Accounting standards also provide information on company disclosure. Better transparency, by providing more information, which is accurate and understandable, will reduce the risk perceived by investors. The risk in question is the accounting risk that comes from the difficulties in understanding the accounting principles and standards applied by the business, and also the inability of investors to process the information provided. By reduced risk investors will get lower returns from their investments, which will result in lower cost of capital as well. The businesses that are using IFRS face less earning management, more earnings, and more value relevance of earnings. This can be due to the easier flow of capital, the reduced costs attributable to the difficulties of adjusting the reports of businesses from different accounting systems. Due to the decreasing costs of processing the information provided in financial reports the efficiency of stock markets will increase, which will result in greater prices of stocks and thus greater capital income for enterprises. All of these factors will provide space for more innovation on the financial markets because they could become more integrated, and more and new international transactions could be created. Due to accounting standards, the international flow of capital will be easier.

International accounting standards are also becoming more popular and tend toward integration as the global economy. The global standards have many benefits that are supported by many factors. However, there also exist some restraining factors. Due to the globalization of the markets, international investors need access to financial information of companies that is easier by harmonized accounting standards. Many economic choices are done when investors realize their activities. These economic factors mostly favor international harmonization. Clear information is needed in order to facilitate investments in all sectors.

Reporting according to IFRS provides much better access to world capital markets, which reduces the cost of capital. Investors cannot easily interpret the given countries' national financial reports. They are very reluctant to invest in companies without clear financials. It is high risk to invest in companies without easily accessible, clear financial reports. Investors expect higher returns from these businesses, thus the cost of debt is higher for the businesses not preparing IFRS reports. IFRS would put the financial statements in a simple and understandable form for investors and other businesses interested in the firm. Such financial reports could have a positive effect on businesses' credit ratings, and thus the cost of borrowing may be reduced. Also, IFRS are widely accepted as the financial reporting framework for companies who would like to get admitted to any of the world's stock exchanges. Since worldwide adoption of IFRS would create a common language for accounting, new capital markets would open for companies who have been reporting only in accordance with their national standards. One can easily say that companies have the opportunity to prepare their financials according to IFRS.

That accounting system differences matter even to financial analysts who specialize in collecting, measuring, and disseminating business information about the covered companies suggests that there are potential economic costs, associated with variation in domestic rules across countries. Besides it is very important for managers and researchers to valuate and analyze the effects of international accounting standards on business decisions, especially their contribution to harmonization and globalization. While a large body of this study is devoted to understanding the causes and consequences of the adaptation of international accounting standards, researchers' attention has thus far focused almost exclusively on the informational benefits for the economic environment, such as the evolution of businesses earnings, division of labor, and the management performance.

The present impetus for global accounting standards follows the accelerating integration of the world economy. The application of international financial reporting standards will allow greater comparison of international financial results. More sources and reports will be available to a greater audience of analysts to follow trends in countries where previously due to different regulations and thus different reports these were less meaningful. The unified financial reporting system will probably lead to new types of analysis and data, furthermore with the possible integration of new indicators from the practice of certain countries.

The author hopes that this book may provide information to bodies and committees addressing both domestic and international universal standards, especially in terms of the impacts of changes in accounting methods. Additionally, the investors may also incorporate into their strategies the experience of individual countries with the adoption of international universal accounting methods in their attempts to implement a harmonized and aligned financial information system. In the author's opinion, entry into international capital markets and the accounting practice of the subsidiaries of multinationals could be greatly facilitated by the increased adoption of universal methods, the reduction of information asymmetry of financial information, as well as the improvement of unified performance and the reliability of the reporting system.

The author considers this volume an initial step toward additional, more detailed, and broader analysis, including inquiries into the future business period also.

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