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Master Thesis Accounting & Auditing

**Accounting for SMEs and suitability of IFRS for SMEs
in Macedonia**

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Abstract

Title: Accounting for SMEs and suitability of IFRS for SMEs
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Five key words: Transition Economy, IFRS for SMEs, Implementation, Suitability, Accounting Regulation and Quality

Purpose: The purpose of the study is to see if International Accounting Standards for Small and Medium sized entities are suitable for entities in Macedonia, with the emphasis on accounting quality.

Methodology: This thesis has an inductive approach. A qualitative method was selected as a strategy and semi-structured interviews were conducted in order to gather relevant information from the respondent.

Theoretical Perspective: The theoretical framework of our thesis, considers the accounting research on the motivations to different accounting practices. Also, the features of transition economies and accounting in these countries are explored.

Empirical foundation: The empirical foundation is build upon eight interviews. The respondents have key positions and possess competence within the area of accounting regulation and practices in Macedonia.

Conclusions: The implementation of IFRS for SMEs will increase the accounting quality and it would be interesting to witness what lies ahead, but always recalling that this is going to be a challengeable process with much difficulty.

Abbreviations

CEE- Central and Eastern Europe

IAS- International Accounting Standards

IASB- International Accounting Standard Board

IASC- International Accounting Standard Committee

IFRS- International Financial Reporting Standards

SME- Small and Medium Sized Entities

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1. Introduction

The first chapter introduces the background of our topic. The problem and the research question are presented. In the end the outline of the thesis is briefly described.

1.1 Background

Many studies have been oriented towards the issues of the developed countries, where the experiences of other countries have not been explored such as those in transition or developing countries. This study aims to touch on issues related to the transition economies in Central and Eastern European countries, particularly in Macedonia. These countries have undergone significant changes in establishing pluralistic society which included political and economic transformation with the emphasis on elimination of central planning and economic command system (Rider and Zajicek, 1995). This transformation is labeled as “transition” that refers to an interim period of regime change. It implies a linear development from beginning towards a clearly defined end goal which is, liberal democracy and a market economy (UNDP, 2005).

As the globalization process took place mainly in western countries, transition countries initiated changes in their system, which is the transformation from planned economy to market economy (Berrios, 2003; Colin, 2009). While transforming from one

system to another, countries face challenges of removing the old command system that produced ineffective economic functioning to establishing the new desired economy (Rider and Zajicek, 1995). However the transition process was followed by many difficulties in the spheres of politics, economy, accounting, business, education and so on (Preobragenskaya and McGee, 2004). Such as the informal sector has not disappeared at all, because the risk of detection by the tax authorities is low (Sokram and Watson, 2008). Regarding the political aspect, King *et al.* (2001) argues that Romania, as a country in transition, is more focused on political issues, rather than on decisions to facilitate the economic change. However, the priority of politics in the transition economies is to attract foreign investments and experiences in fostering trade liberalization (*ibid*).

Privatization of state owned entities was also a tool in a shift towards the creation of an efficient and dynamic market economy (Rider and Zajicek, 1995). However the privatization process faced difficulties too, lacking in resources and capabilities to face competitive markets of developed economies (Dixon *et al.* 2010). This is because politically-favoured entities had no opportunity to reach the needed innovation by the market since their gains were still imprisoned by the state (Rider and Zajicek, 1995). Nevertheless, the most important reason in privatizing the state owned entities is the transfer to private hands to achieve efficiency and innovation (*ibid*).

In order to follow their self interest and support their changes to a market economy, most of the transition countries voluntarily relied on Western features to curry their weak financial infrastructure and, to some extent, imitate the financial markets of the developed western countries (Young *et al.* 2002, p.4). Furthermore, these changes were also initiated from the desire to get access and integrate to the European Union (EU) (Bailey, 1995).

Firstly, the development of the financial system in transition economies was followed by the separation of the central bank and commercial bank activities, where the process of privatization has played an important role in shifting towards a market economy (Berglof and Bolton, 2002). Secondly, as mentioned in the previous section, the difficulties in the transition process and the inappropriate procedure of privatization of

politically favoured larger entities has not fostered the development of equity markets (ibid), therefore banks are the main finance providers.

Accounting was followed by many changes too, but still having the traces of the old system where state influence continues to shape the notion of accountability (Bailey, 1995). According to Daniel *et al.* (2001), the accounting system in Slovakia, as a country in transition, was determined by the political objectives and economic policy of the government.

Counteracting factors which adversely affect the accounting development include the former function of accounting, having the macroeconomic role of supplying data to the needs of national statistics and mainly having a bookkeeping role, the prevalent interaction of accounting practice and fiscal policy, the weak development of accounting profession (King *et al.* 2001). However, the challenge that the transition countries face is the creation of an independent accounting profession (Daniel *et al.* 2001).

The process of reform in an accounting system in transition countries is taking place towards International Financial Reporting Standards (IFRS) in order to fulfill the requirements of the EU. This process is characterized by slow movements since there are no local accountancy and audit professionals capable to contribute to the accounting system reform (Sucher *et al.* 2005). For example, there is no appropriate professional organization in Macedonia (like in many countries) as a country in transition since the Association of Accountants, Financial Workers, and Auditors established in 1956 is lacking capacity and practically inactive (Markovska, 2005).

1.2 Problem

Due to the inappropriate privatization of large state-owned entities, the development of equity markets has been very slow in transition economies, leading to the development of small and medium size entities (SMEs). Many authors argue that SMEs are playing a

crucial role in establishing a good economic climate in transition economies (Dallago, 2003). Dallago further argues that the successful sector of SMEs is a successful transition process at the same time.

Following the transition reforms, SMEs “comprise the vast majority of incorporated enterprises and are also the main source of wealth creation and employment of transitional economies” (Son *et al.* 2006, p.218). Similarly, other authors argue that SMEs play a central role in job creation and, in general, assure social stability and economic development (Mullerova *et al.* 2010).

Many countries fostered the growth of this particular sector. For example, the SME sector is the healthiest economic driver in Macedonia. SMEs comprise 99,7 percent of the total entities registered as limited liability entities (Ministry of Economy of Macedonia, 2007). Additionally, the recent law on these entities has initiated the growth of these entities from 40.000 to 50.000 in 2007. The law requires a minimum 5.000 Euros of capital in establishing the entity, which may comprise of assets other than cash. The law also introduced the “One-Stop Shop” system for simplified business registration, reducing the fees and time needed for registration in a single bureau in the Central Registry (European Commission, 2007).

Due to the discussion above about the importance of the SMEs sector in transitional economies, the question has been raised about financial reporting of these private entities whether the full IFRS are suitable for them (Evans *et al.* 2005). While there is a transparent financial reporting requirement for listed entities, it is also important for SMEs to have suitable accounting standards because of the increasing importance of SMEs in the global economy and arguments urging the differential reporting caused new proposals for financial reporting of these entities such as IFRS for SMEs (Evans *et al.* 2005).

Furthermore, it is important to identify the patterns arising from the users’ perceptions of the information in the financial reports of SMEs (Son *et al.* 2006) in a transitional economy, particularly as in our case in Macedonia. For example, banks

require information about the capabilities of the entity to pay their debts in order to facilitate the lending procedure; government needs to determine the taxable income (ibid). Tax authorities have privilege to demand any kind of information they need to meet their tax estimation and collect obligations from entities (Schiebel, 2007). It is also important to mention that financial reporting practices are influenced by the accounting systems of the two models that are of Anglo-Saxon and Continental model (Nobes and Parker, 2008) in order to determine the country specific perspectives, that is, the users' perceptions of financial reports of SMEs. Therefore, it is worth taking into consideration the factors (such as the legal system, culture, the profession, providers of finance) that affect the financial information provided to the users of SMEs, in this case in transitional economies. We have found out that there is no study about this issue when reviewing the literature, therefore focusing on multi-user perception of financial reports of SMEs in a transition country makes a contribution to this area.

International Accounting Standards Board (IASB) claims that standards issued by them are suitable for all entities, however related to users' perspective issue this question should be asked: Who are the users of financial information provided by SMEs? Literature reveals several users of corporate financial information such as: equity investors, loan providers, employees, analysts, the government business contacts and the public (Son *et al.* 2006). Small and medium entities, by contrast, have different goals from large firms, therefore their financial reporting differ referring to their notion of "non-public accountability," since they are not listed and do not have equity investors (Evans *et al.* 2005). Some studies reveal that the main users of financial information of SMEs are owners-directors (Jarvis and Collis, 2003), while others argue that the tax authorities and banks are the main users of financial information provided by SMEs (Page, 1984). The discussion above shows a diversity of findings by the authors regarding users and their uses of financial information in developed countries. It seems that there is very little knowledge about this particular issue in transition economies such as our case in Macedonia.

The literature on IFRS for SME explores that these distinctive standards are suitable for entities that do not have public accountability and publish general purpose financial statements for external users such as owners, current and potential creditors and credit rating agencies excluding government and tax authorities (IASB, 2007; Evans *et al.* 2005); therefore it is important to address this issue in Macedonia as a country in transition. Additionally IFRS for SMEs emphasizes the accounting quality, respectively the financial information quality as the determination of a good accounting practice. Therefore we ask this question:

-Would the IFRS for SMEs as simplified standards be appropriate for the entities in Macedonia?

In order to investigate the appropriateness of IFRS for SMEs, we will first look at the current accounting rules applied for SMEs in the country, respectively, if they are similar or different from the notion of the IFRS. Additionally, we will also look at the accounting quality and the factors that impact and shape the notion of it.

Therefore the discussion above leads us to our question formulations and the purpose of the thesis:

-Would the IFRS for SMEs as simplified standards be appropriate for the entities in Macedonia?

-What are the current accounting rules applied for SMEs?

-Which factors determine the accounting quality for SMEs in Macedonia?

This thesis will answer these questions in order to determine the appropriateness of IFRS for SME, where the current rules and accounting quality is an essential point in the application of these standards in a country in transition.

1.3 The Purpose

Our research question aims to clarify the appropriateness of IFRS for SMEs in Macedonia. In order to investigate the suitability of IFRS of SMEs for entities in Macedonia, we have found it necessary to see the current accounting rules applied for these entities, respectively, how the accounting regulation is built in the country. Furthermore, we will also look at factors determining the accounting quality in a country.

Since the equity markets are underdeveloped in these countries, SMEs comprise most of the entities in the economy. Our focus of analysis will be on non-listed entities, which is in-line with the applicability of IFRS for SMEs as simpler, shorter, more understandable, and cheaper to be implemented.

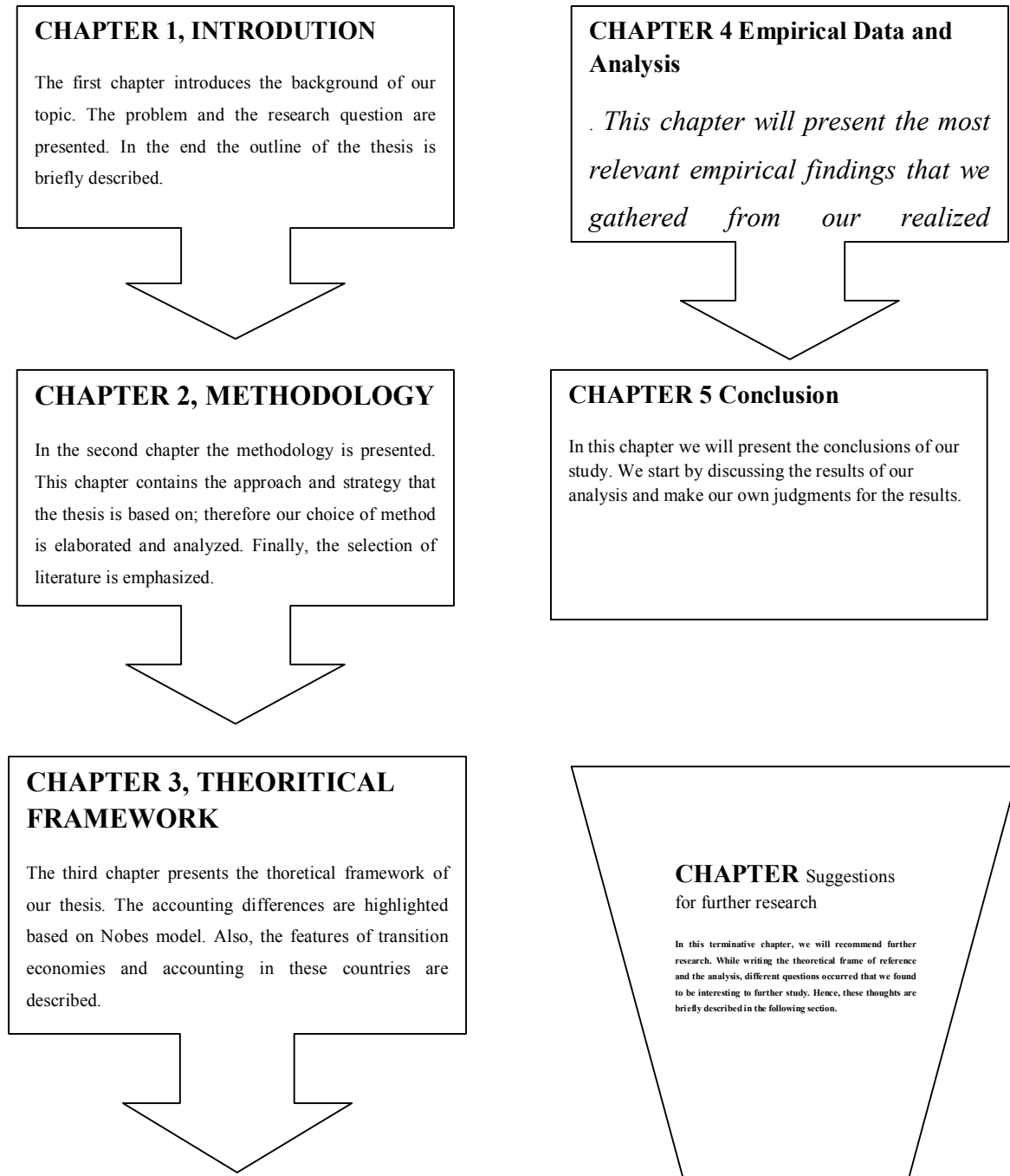
In order to achieve our thesis purpose and answer our formulated questions, we will ask accounting practitioners, accounting academics, Ministry of Finance officials as the accounting regulatory body, accounting consulting firms, and banks—as financial information users, to address our problem. As stated in the previous sections, the old command system has left traces and still influences the accounting system of the transition economies such as supplying data for the national statistics, collecting taxes, etc.

1.4 Contribution

The available accounting research was mainly based on developed countries where other countries such as those in transition are not well explored. This thesis will contribute to understanding how accounting regulation is set to SMEs in a transitional country such as Macedonia, considering the statutory regulations (the state) or meeting the needs of other users for economic aims. Our thesis will also contribute to the issue whether the IFRS for SME, as simplified standards, are suitable for the entities in transition countries with the emphasis on accounting practitioners, accounting academics, accounting consulting firms and accounting regulatory body (Ministry of Finance). Our

study could also contribute to implications of different accounting practices regarding the accounting system that is installed in Macedonia.

1.5 Outline



2. Method

In the second chapter the methodology is presented. This chapter contains the approach and strategy that the thesis is based on; therefore our choice of method is elaborated and analyzed. Finally, the selection of literature is emphasized.

2.1 Research Approach

Literature classifies two main research approaches: deductive and inductive. Authors also emphasize the differences between these approaches, where the deductive approach “represents the commonest view of the nature of the relationship between theory and research” (Bryman and Bell, 2007, p.11). This means that research is conducted based on what is already known about the particular phenomena. The deductive approach further establishes a hypothesis that are subtracted from the specific literature collected and then the hypothesis will be confirmed or rejected based on findings (Bryman and Bell, 2007).

Since there are no early studies in our area of interest, our thesis will be based on an inductive approach. The inductive approach represents an opposite approach from the deduction, where the researcher applies his findings in establishing the theory. Qualitative data is mostly concerned with the inductive approach, where “the theory is the outcome of research” (Bryman and Bell, 2007, p.14).

Additionally, our experience will be applied (if necessary) from working in an accounting office, from the practices of recording transactions to the preparation of the financial statements for SMEs. The empirical study consists of conducting interviews with particular professionals in the accounting field, academics, accounting regulatory body (the Ministry of Finance in this case), accounting consulting firms, and banks.

2.2 Research Strategy

2.2.1 Qualitative Research Method

We have used the qualitative approach as a research strategy for our empirical material. Qualitative research is concerned with words rather than numbers, where the meanings of the words will create the context (Bryman and Bell, 2007). Since there is no study on our interest area, the qualitative method will facilitate us to interpret the actions and the perspectives of the subjects studied (Alvesson and Sköldberg, 2009).

We will use the qualitative method because we want to hear “words” from our respondents’ experience and knowledge on the field, meaning, we want to know what is happening in reality. Another reason for choosing the qualitative method, as presented by Son *et al.* (2006) in their study about the transitional economy, is the unreliability of economic data and problems appearing in managing quantitative surveys in transitional economies which makes it difficult to conduct a deductive approach in Macedonia as a country in transition.

Additionally, the qualitative approach will allow us to notice new possibilities emerging in a transition country related to the accounting standards for SMEs that will either support or neglect the idea of the suitability of IFRS for SMEs that is presented as our research question. In this aspect, reliance on earlier theories and literature which represents the deductive approach will highlight the old problems (Alvesson and Sköldberg, 2009) that transition country face, where the new possibilities are difficult to be investigated.

Other methods presented by Bryman and Ball are: participant observation, discourse analysis and focus groups. We are aware that the absence of the quantitative

method limits our study to a certain extent. However our experience in accounting will be taken into consideration.

2.2.3 Semi-Structured Interviews and Empirical Information

Our purpose is to grasp the respondents' experiences and perceptions from the accounting field with the emphasis on SMEs that is from a user, accounting professionals, accounting regulatory body, accounting consulting firms and academics' perspectives. We have conducted semi structured interviews (see the questions in Attachment 1) with the respondents. All the interviews were recorded and carefully transcribed.

We have conducted direct, face-to-face interviews and get as much as possible information from them. We have also carefully explained the background of our thesis in order to get detailed and valuable information and avoid the risk of unclear answers. As Bryman and Bell (2007) suggest, we have tried to be active and avoid intrusiveness.

Furthermore, semi-structured interviews allowed us to take a more flexible approach, in asking additional questions during the interviews, to pick up other relevant information important to us. Additionally, in order to get valuable answers from the respondents, the interview questions were sent in advance.

2.3 Critique of Qualitative Research

There is also a criticism to the qualitative research that has to be taken into consideration. Bryman and Bell argue that qualitative research is too subjective and impressionistic, which means that the findings depend on the researcher's view and ends with the open-ended manner. Additionally, qualitative approach is time-consuming which makes the findings fragile. Due to this fact and the risk of limited number of respondents in

Macedonia, it was difficult to get access to important interviewees that were located in the country and where the density of SMEs was high. Therefore, we have used a *strategic approach* where the knowledge and experience of the respondents are taken into consideration. We are aware those interviews could represent small scale aspects of reality (Bryman and Bell, 2007). However we believe that the respondents will provide us with important information and general conclusions will be extracted.

2.4 Other Considerations

We also want to highlight other considerations that, to some extent, affect our qualitative approach. Our interviewees' answers are in Albanian and Macedonian language. The first risk appears when we translate the words and the meanings into English that could cause the distortion of the empirical material and increase the sensitivity of the words and the meanings.

2.5 Information Gathering

We have used a combination of primary and secondary sources (literature) that served us in conducting our study.

2.5.1 Primary Data

Primary data was gathered by our interviews with the accounting practitioners, accounting regulatory body, accounting consulting firms, accounting academics, and banks.

2.5.2 Literature

Our main goal in gathering the literature was finding the appropriate information regarding the accounting differences in different parts of the world, international standards in accounting with the additional emphasis on small and medium size entities, economies in transition and their accounting features.

The literature was gathered mainly through Lund University electronic databases. The main database used was ELIN where we had access to different business journals and articles. The journals such as “Accounting in Europe”, “The International Journal of Accounting”, “Journal of Accounting and Public Policy”, “The European Accounting Review”, “Journal of Economic Perspectives”, provided us with the important information that have been carefully studied. The main key words used while searching for the articles were: “IFRS for SMEs”, “IFRS and transition economies”, “IFRS and accounting differences”, “accounting and transition economies”, “financial reporting for SMEs”. Additionally, we have also found working papers that were downloaded from Google using the same keywords mentioned above. Some of the literature was taken from the bibliographies stated at the end of the articles which provided us with relevant information.

3. Theoretical Framework

The third chapter presents the theoretical framework of our thesis. The accounting differences and motivations to different accounting practices i.e. accounting qualities are highlighted based on the Nobes model. Furthermore, the heritage of IFRS for SMEs is elaborated. Also, the features of transition economies and accounting in these countries are described.

3.1 Accounting Development and Motivations to Different Accounting Practices

Accounting has undergone significant changes in transition economies, and it has evolved from a technical topic to a scientific one, respectively accountants had been perceived as “bean counters”. But later with the development of complex domestic and global markets accounting has become a socially embedded practice that influenced particularly the wealth accumulation (Carruthers, 1995).

As it is broadly known financial statements provide information about the entity’s financial position, financial performance and the cash flow. Entity’s stakeholders are particularly interested for this kind of information. However there are differences in financial reporting in different countries, as Nobes and Parker (2008) define those as accounting systems. They argue that “if a number of accountants from different countries, or even one country, are given a set of transactions from which to prepare financial statements, they will not produce identical statements” (p.4), though there are endeavors to reduce them particularly by International Accounting Standards Board (IASB).

In this part we will briefly introduce the accounting differences based on Nobes model, and also point out the harmonization process especially in Europe. Then we will

further elaborate the International Financial Reporting Standards (IFRS) for Small and Medium-sized entities (SMEs) and discuss the differences from the full IFRS, and at the end, we will evaluate economies in transition and their application of international standards since it is our area of interest.

3.2 Nobes model and International Differences

International differences in financial reporting fostered international classification of accounting systems in order to understand the complexities of accounting practices in different parts of the world (Sellhorn and Tomaszewski, 2006). Nobes (1998) in a simplified manner suggests dividing countries into two main groups. Similar accounting practices of the entities in different countries are grouped in a single group of accounting system (Nobes and Parker, 2008), in fact they are classified as (Nobes, 1998):

-countries with significant equity markets

-countries with a credit based financing system and relatively weak equity markets

Nobes (1998) further argues that financial reporting has different objectives in these accounting systems; furthermore one country could have various systems subsequently in the light of accounting harmonization i.e. the harmonization in EU, internationalization of equity market (Haller, 2002) and compliance with IFRS will initiate countries move to the first accounting model. Before going further we have considered these causes for international differences such as: legal system, finance providers, taxation, and the profession. Reflecting on these factors we will determine whether transition countries belong to the first or second group of countries. Additionally Soderstrom and Sun (2007) refer these groupings as “accounting qualities,” that is to say, how is accounting quality perceived in each group.

3.2.1 Countries with Significant Equity Markets

Nobes's first model of countries with significant equity markets is also referred to as an Anglo-Saxon model. Industrial revolution and economic development in nineteenth century promoted establishment of capital markets where the risk was distributed to variety of creditors and investors. Therefore the requirement of informing the investors about the entity's operations emerged as priority of financial reporting, which is shareholder orientation.

First of all, this development could be claimed for the UK accounting system as an industrial revolution inherited from there, and also for the US accounting system. These countries, also including Australia, Canada and New Zealand are based on a common law legal system which influences commercial law (Nobes and Parker, 2008), in other words, regulation. Common law countries are more likely to use less conservative and less secretive accounting standards regarding the cultural aspect (Ding et al. 2005)

Based on the arguments above, the main providers of finance for the most entities are individual and group shareholders, i.e. institutional investors. This also indicates that these countries are characterized by more listed entities than other countries (ibid) as those in the second model. Nobes (1998) argues that an entity's accounting practice will be mainly determined by the financing sources.

Taxation is another reason that causes differences in the accounting system. As argued earlier financial information for these countries has the objective of informing the shareholders rather than the strong connection between financial reporting and tax.

Consequently the accountancy profession could be seen as a cause for international differences that is the competence, strength, and size of the profession (Nobes and Parker, 2008) is to some extent higher in Anglo-Saxon countries, as the larger capital markets necessitate the need for accountants and auditors rather than tax experts.

3.2.2 Countries with Weak Equity Markets

The second prevalent classification by Nobes is that of countries with weak equity markets known as the continental model. The main notion of financial reporting is obeying the rules in order to insure creditors and satisfying the state. The impact of Napoleonic Commercial Code issued in France in the seventeenth century has been perceived as an influence on the continental model, in other words the influence of the state (Nobes and Parker, 2008).

By contrast from the first model, the legal system in these countries such as Germany, Italy, France, Netherlands, Spain etc., is based on code law, even though the Netherlands is an exception due to the significance of its capital market (Nobes and Parker, 2008). Here the idea is based on the rules governing the accounting practice and protecting the creditor. A Cultural paradigm in this grouping will be that code law countries are more likely to use more conservative and prudent set of accounting standards (Ding et al. 2005).

The major capital providers for these countries are banks, rather than relying on shareholders (Nobes and Parker, 2008). It is not to say that these countries do not have equity markets at all, since these arguments are in relative terms. Therefore, by contrast these countries have less listed entities than the previous group of the countries with significant equity markets.

Tax system to great extent affects the financial reporting in the continental model. It is relevant to emphasise that “for these countries it is largely the case that tax rules are the accounting rules” (ibid, p.33) indeed, which means that financial reporting is closely related to taxation.

As indicated in the previous section the professions’ strength, competence and size, by contrast is perceived lower in the continental model, on the other hand, the need for tax experts could emerge, due to the fact that accounting is closely related to taxation.

For example in Germany there is a larger body of tax experts than the accountancy body (ibid).

3.3 Accounting Harmonization in the EU

As can be seen from the section above, there is evidence that there are accounting differences taking into consideration the accounting systems installed by different countries in different parts of the world. However attempts for harmonization condensed the accounting differences to some extent, considering the need of comparable accounting information by the shareholders and other important stakeholders. Ding et al. (2005) claims that there are several reasons for international accounting harmonization, but the most important are the growth of importance of the international capital markets in economic resource distribution, the spread of multi-listed entities as an emergence of unique set of accounting standards and internationalized institutional investors.

Haller (2002) argues that accounting harmonization among the EU represents a political task in the process of achieving a unified European economic market. On the other hand, Sellhorn and Tomaszewski (2006) claim that political and economic forces will always shape the accounting practices with the aim to improve the internal and external decision making process, respectively the management and the stakeholders. That is, entities will use different accounting practices depending on political and economic circumstances that could cause further implications in differences in accounting systems.

It is also fruitful to mention that the EU mainly uses the standards issued by the IASB (IFRS endorsed by the EU) which are based on principles. The underlying notion of principle based standards is that they require professional judgement, which is they do not cover every issue or in other words there are no bright line rules (Carmona and Trombetta, 2008). These standards are also characterized by the conception of flexibility and openness (ibid).

In 2005 IFRS were made mandatory to be applied by all listed entities within the EU in preparing consolidated financial statements (e.g., Haller, 2002; Carmona and Trombetta, 2008; Degos and Ouvrard, 2008). Therefore, accounting directives provided by the EU are the main instruments in the harmonization process within the member states. In turn these directives will be briefly introduced.

3.3.1 Accounting Directives

The main instruments to achieve the accounting harmonization in the EU were the Fourth and Seventh Directive (e.g. Haller, 2002; Nobes and Parker, 2008). The EU members are gratified to implement these directives into their national law.

The fourth Directive embraces the preparation of the annual financial statements and valuation requirements for private and public entities, where the concept of true and fair view was pioneered and influenced by the UK (Nobes and Parker, 2008). Other issues covered were the disclosure requirements to be increased (Haller, 2002).

The seventh Directive covered consolidation where the concept of a group was identified, that is the preparation of group financial statements and consolidation methods (Haller, 2002), in order to enhance the comparability of financial information especially for multinational entities.

3.4 Implications and Effectiveness of Harmonization

As mentioned in the Nobes model, most of the European countries, except the Netherlands, belong to the continental model of accounting system. The main notion of this model is the significant relationship between accounting and taxation. Finance providers are mainly banks; hence the accounting system is oriented towards creditor

protection. Therefore Ding et al. 2007 argues that the absence of the IFRS/IAS approach determines the weakness of equity markets especially in emerging and transition economies. On the other hand the harmonization process affected country's accounting practice, establishing "duality" (Sellhorn and Tomaszewski, 2006) in financial reporting that is, one for information purposes, and the other for taxation purposes. This indicates that changes in accounting practices towards issuing useful information to the public is consistent with the Nobes argument for accounting harmonization, since countries will move to the Anglo-Saxon model. This seems like very reasonable and moderately easy to argue, though accounting differences are not shrunk at all, there are still differences.

Haller (2002) argues that even though harmonization process was an effective tool of harmonization, "nevertheless, all this cannot hide the fact the harmonization through the directives has not provided a satisfactory level of comparability and equivalence between financial statements within Europe, which means that the contents of the accounts and financial figures are often so different that they cannot be compared and analyzed decently" (p.159) and let aside the IFRS for SMEs. This fact seems to allude to countries that maintained their customary accounting system. Therefore the distinction between public and private entities, consolidated and individual financial statements is useful (Sellhorn and Tomaszewski, 2006). France for instance, applies IFRS standards for listed entities, but on the other hand, there is an option of usage for non-listed entities (Degos and Ouvrard, 2008), that is IFRS is not required; it is still optional.

German individual entities are permitted to prepare IFRS either US GAAP financial statements but at the same time, they must prepare under national German GAAP (Nobes and Parker, 2008).

On the other hand, Daske et al. 2007 distinguishes between mandatory and voluntary adopters of IFRS/IAS. They argue that entities that are voluntary adopters are "serious" adopters indeed, which means that is to their interest to comply with the international standards and they are significantly affected by the equity market. On the other hand, mandatory compliance with IFRS/IAS, especially after 2005, has indicated that these adopters exploit the openness and flexibility of IFRS/IAS standards to maintain

their traditional accounting practices (Carmona and Trombetta, 2008) and are only “label” adopters which question again the accounting harmonization and improvement.

Daske et al. 2007 argue that mandatory adoption did not have strapping effects particularly in jurisdictions where the national GAAP differed quite evidently from IFRS/IAS standards. Therefore accounting harmonization and implementation of international standards is a real challenge (Hoogendorn, 2006).

Haller summarizes accounting differences into four dimensions (Haller, 2002 p.173):

- the scope of regulation which covers foreign or/and domestic companies
- mandatory or optional use of IAS/IFRS or US GAAP
- the obligation of compliance with national GAAP when financial statements are prepared with IFRS/IAS or US GAAP
- the compliance with IFRS/IAS or US GAAP for consolidated financial statements only or financial statements in general

As pointed out above there are inconsistencies among the European accounting system and regulation in a widespread convergence towards standards issued by IASB. The fact is that the linkage of accounting and taxation has made long term traces, concerning the financial reporting, where the IFRS/IAS compliance is made as an option which to some extent impairs the process. The classification of voluntary and mandatory adopters has also made some implications on the global acceptance of international accounting standards.

3.5 The emergence of New Accounting Model

The sections above indicated that accounting harmonization intend to abolish accounting differences within the EU. The most notable evidence is the year 2005 when the IFRS became mandatory to all listed entities, but emphasis has not been put to other entities

such as individual and smaller ones. However there are options in different countries in complying with IFRS/IAS either the national GAAP to individual and smaller entities. Therefore Sellhorn and Tomaszewski (2006) suggest a reclassification of accounting systems based on Nobes model and the appearance of different accounting practices for different entities. Two criterions provided by them are:

-the distinction between publicly traded and non-publicly traded entities and

-the distinction between consolidated and individual financial statements

Criteria ► ▼	Consolidated financial statements	Individual financial statements
Publicly traded entities	<u>Group 1</u> IFRS required	<u>Group 2</u> Option for Member State to require or permit IFRS
Non-publicly traded entities	<u>Group 3</u> Option for Member State to require or permit IFRS	<u>Group 4</u> Option for Member state to require or permit IFRS

Source: Sellhorn and Tomaszewski (2006)

The table above summarizes and gives a clear answer why there are still accounting differences within the EU and also other countries where the IFRS are accepted. This all depends on the accounting regulation set up by the state especially for Group 2, 3 and 4. These groups indicate that most of the countries require or permit the use of IFRS. Tendency of countries that permit the use of IFRS for individual accounts (Group 2) are those of the Anglo-Saxon model such as: UK, Ireland, the Netherlands etc., where there is a strong equity market.

As expected countries belonging to the Continental model, which is most of the European countries, will prohibit the use of IFRS or require both IFRS and national GAAP financial statements, because of the traditional linkage of accounting, taxation and creditor protection. For this reason, Veerle (2005) argues that harmonization is only achieved in the aspect of consolidated financial statements of listed entities, therefore the gap could be widened for consolidated and individual reporting that creates further disharmony rather than harmony within the EU.

Group 4 concepts of individual financial statements and non-publicly traded entities are non listed entities where most of the states permit the use of IFRS rather than require them. However these private entities voluntarily adopt IFRS/IAS. A study conducted by Francis et al. (2008) note that an entity's specific incentive, such as external contracting, facilitates the voluntary adoption of international standards.

Since it is our area of interest the notion of non-publicly listed entities overlaps with the notion of Small and Medium-sized Entities. The following sections elaborate the notions of SMEs as a need for distinct accounting standards since full IFRS are too costly and complex for smaller entities (Sellhorn and Tomaszewski, 2006). Emphasis will be given to transition economies due to the fact that these economies are mainly driven by small and medium entities since they have weak and underdeveloped equity markets.

3.6 The Heritage of IFRS for SME-perspectives from 2004

As stated earlier the need for distinct reporting standards for small and medium sized entities fostered IASB to issue a Discussion Paper in 2004, at a time when an initiative started on accounting standards for these entities. This paper has received around 120 responses from the profession, academics, regulators and others interested to this issue (Evans et al. 2005).

The IASB which has issued and developed International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) presumed that these standards are ultimately suitable for reporting purposes of the listed corporation, as well as for other entities, respectively providing financial information based on IAS/IFRS concepts and principles. However, there are critical reflections to this argument, whereby the suitability of these standards could be questioned to meet the needs of small and medium-sized entities, which are non-listed enterprises (Evans et al. 2005); therefore there is the call for particular standards for SMEs.

The requirement for special standards for SMEs indicates the importance and economic impact of these firms with the argument that approximately 99% of businesses across Europe comprising of small and medium sized firms (ibid). This again confirms the importance of SMEs in the global economic environment with the emphasis in job creation which facilitates social stability and economic development (Müllerova et al. 2010).

Many authors argue that the need for special standards for SMEs could lead to examining advantages and disadvantages of applying special reporting by these firms, costs and benefits, conceptual problems such as agency and stewardship function, user needs of SMEs weighting against listed corporations. Based on European Accounting Association (EAA) Financial Reporting Standards Committee comments, (presented by Evans et al.2005) the main disadvantage of special reporting by SMEs could be the outweighed costs of reporting as IFRS are perceived to meet the needs of capital markets and there is no need for complex accounting. Other disadvantages appear because there are smaller user groups (such as banks as creditors, tax authorities, management) than for listed entities. On the other hand, advantages of special reporting by SMEs are achieving the “well-known” universality, comparability, public interest, transparency, reliability as the IASB framework requires. The agency relationship as a conceptual problem will differ for SMEs mainly from the absence of the owner-shareholder relationship, except the relationship between the owner or owners with the bank as a focal creditor which further lessens the stewardship function (Jarvis and Collis, 2003).

Another particular issue is how SMEs are defined, where the EU applies assets, turnover and number of employees (Evans et al. 2005), thus the objective of financial reporting should be clarified (as IFRS are inclined towards listed entities) and convey with SMEs the notion of the “non-publicly accountable entities.” In this line of argument the qualitative characteristics rather than quantitative, which are based on size, are endeavoured by the IASB (Degos and Ouvrard, 2008).

3.6.1 Comments on the IASB’s Exposure Draft “IFRS for Small and Medium-Sized Entities. Some Responses and Implications

As it was elaborated in the previous section, the Discussion Paper on ‘Preliminary views on Accounting Standards for Small and Medium-Sized Entities that was published in 2005, the need for IFRS for SMEs was determined. After this the IASB issued the Exposure Draft of a proposed IFRS for Small and Medium-Sized Entities which was opened to comments and questions that have been increased in the context of the Exposure Draft (Pietra *et al.*, 2008). The aim of the comments and questions was to obtain the results of whether the IASB should produce separate standards for Small and Medium-Sized Entities (Pietra *et al.*, 2008).

Based on the review of the responses to the Discussion Paper, the IASB set up a subcommittee of the Board that will have to deal with these issues, therefore it was concluded that there was a need for SME standards, and as a response, the Board developed the Exposure Draft (Pietra *et al.*, 2008). The project should be useable by non-publicly accountable entities (NPAEs) and the decision that should use the IASB standards for SMEs is made by national authorities and standard setters or a professional accountancy body. The Exposure Draft considers SMEs as a homogeneous group and assumes the same accounting rules for a common group of users that are distinguished by the same needs. The reference point of this draft was the existing framework of IFRS,

therefore they assume that establishing new standards will change rules and objectives which will be costly and time-consuming (Pietra *et al.*, 2008).

Another issue that has to be taken into consideration is the definition of the non-publicly accountable entities (NPAEs). IASB that uses a very general definition with the focus only on large entities and it is questioned whether IFRS for SMEs can be appropriate for smaller entities which can result to the complexity of the rules by accepting the standards (Pietra *et al.*, 2008).

SMEs are perceived as the most vibrant and healthier sector of the CEE (Central and Eastern Europe) economies in comparison with the larger entities (Klapper *et al.* 2002). Facing the problem of complexity, these jurisdictions will have difficulties in deciding which types of entities should be subject to IFRS for SMEs (Pietra *et al.*, 2008). Daly (2009) argues that the IASB defines SMEs as not having public accountability, and moreover, the definition has little to do with the size, since those entities that are closely related to public accountability, or are a subsidiary of a listed entity, would use the full IFRS.

Accordingly, Eierle and Haller (2009) argue that size has a little impact on the notion of SMEs, therefore the accountability issue depends on international exposure, the structure of the entity, and the specific accounting issue.

Countries will be faced with the costs and benefits in applying IFRS for SMEs, where researches have revealed pros and cons that have to be taken into consideration by countries, especially by those in which the majority of the economy comprises of small and medium sized entities (Pietra *et al.*, 2008).

Small businesses have different objectives in providing the financial information, one reason for that is the credibility of the financial information (Pietra *et al.*, 2008). On the one hand, the use of IFRS for SMEs embrace many advantages including harmonized global reporting environment, improved information quality, increasing number of SMEs operating internationally, opportunity to demonstrate better results and improving reliability and comparability of financial information in an international context. On the

other hand, there are disadvantages of implementing IFRS for SMEs associated with the high costs, lack of technical expertise, competitive disadvantages, and complexity of standards (Pietra *et al.*, 2008).

Another important aspect of implementation of IFRS for SMEs is the issue related to the “fair value,” that is the definition and the use of the fair value (Pietra *et al.*, 2008). According to Paoloni (2006, cited in Pietra *et al.*, 2008) SME strategies are controlled by owners and the main users of financial statements are finance providers and the state, also shares are not publicly traded, and as a result, the fair value loses the importance because the additional information adequate to the measurement is not provided.

As we mentioned earlier, financial reporting for SMEs is derived from the full IFRS that can be used by smaller and non-listed companies, therefore this can be an incentive for entities as well as countries for an easier transition to the full IFRS (Epstein and Jermakowicz, 2007). As can be seen, the standard is considered to be used by SMEs that have no ‘public accountability’ and they issue general purpose financial statements for outside users mainly for banks and the state, on the other hand, an entity is considered to have public accountability if it has instruments for trading in public markets, holds assets in a fiduciary capacity, and applies an effective interest method for calculating the amortized cost of financial assets (Fisher, 2007).

3.6.2 Differences between full IFRS and IFRS for SME

Compared to the full IFRS the proposed standards for SMEs have been reduced by more than 85% to 255 pages (Pontoppidan, 2008), this was accomplished by modifications to the content of the full IFRS, for instance, eliminating topics, eliminating certain choices of accounting treatments and simplifying methods for recognition and measurement (Epstein and Jermakowicz, 2007). These modifications are grouped into three areas that have been viewed as not relevant to typical SMEs. According to Epstein and

Jermakowicz (2007) “*omitted topics*” from the proposed IFRS for SMEs are as follows (derived from IASB, 2007):

- ✓ General price-level-adjusted reporting in a hyperinflationary environment
- ✓ Equity-settled, share-based payment
- ✓ Determining the fair value of agricultural assets
- ✓ Extractive industries
- ✓ Interim reporting
- ✓ Lesser accounting finance leases
- ✓ Recoverable amount of goodwill
- ✓ Earnings per share, segment reporting, and insurance contracts.

A second modification was that accounting policy choice “*only the simpler option*” is included in the proposed IFRS for SMEs such as (IASB, 2007):

- ✓ The cost-depreciation model for investment property
- ✓ The cost-amortization-impairment model for property, plant, equipment and intangibles
- ✓ Expensing of borrowing costs
- ✓ The indirect method for reporting operating cash flows
- ✓ One method of accounting for all governments grants

Moreover, a third modification “*recognition and measurement simplifications*” include (IASB, 2007):

- ✓ Financial instruments

- ✓ Goodwill impairment
- ✓ Research & Development
- ✓ Joint ventures
- ✓ Simplified accounting for deferred taxes
- ✓ Agriculture
- ✓ Defined benefit plans
- ✓ Share-based payment, finance leases and
- ✓ First-time adoption.

All these modifications are incorporated in the exposure draft IFRS for SMEs which has special importance as well as impact on the prospective accounting and auditing standards, therefore as a result the success of the IFRS for SMEs will depend on the extent to which users, preparers, and their auditors believe the standards meet their needs (Epstein and Jermakowicz, 2007). These simplifications could facilitate the adoption of these standards by other entities such as those in transition economies where the multi-layered social and economic development is in process. First, we will briefly introduce the main notions of transition economies and then point out their accounting characteristics.

3.7 General Features of Transition Economies

Countries of Central and Eastern Europe (CEE; including the Balkans) are the examples of the transition economies. These countries followed the Soviet Union model especially after the World War II by inaugurating command systems that were governed by central

planning, that is, by the state (Berrios, 2003). However after the 1990s, these countries were disembodied by this system and attempted to switch to market-based economies by transforming their political, economical, and institutional prospects since the system did not provide growth; though these structures are still influenced by the state (UNDP and LSE, 2006). Therefore Berrios argues that “the shift to the market has altered the behaviour of many enterprises and the labour force, there is still a bureaucratic culture that lingers from the old command system, causing delays and inefficiencies. The privatization process was supposed to bring about greater efficiency and competitiveness. However the process itself was marred by a lack of transparency.” (Berrios, 2003, p.322).

Although the growth performances of these countries are evident where the GDP growth shifts from 4-8% rate, where the process of globalization has played a vital role and markets opened the doors especially to foreign direct investment (FDI) inflows (UNDP and LSE, 2006). Also the impact of European integration and potential access to the EU fostered thriving transformation of these economies (ibid).

Considering the reform process taking place in Central and Eastern Europe and the transition towards “marketization” the so-called second economy has not disappeared (Colin, 2009), and it is a controversial issue that these countries have to deal with. The author has named this process the “hidden economy” which is a crucial issue across Central and Eastern Europe. The definition of the hidden economy includes many nouns and adjectives for instance, ‘cash in hand’, ‘undeclared’, ‘shadow’, ‘informal’, ‘black’ and ‘underground’ economy/sector/work (ibid). The article reports the survey’s findings for only ten Central and Eastern Europe countries that are now member states of EU. Also the article divides the hidden work into two types ‘undeclared jobs’ where none of the income is declared to the state and ‘under-declared jobs’ where a registered employee is paid two wages by the formal employer, official declared wage and unofficial undeclared wage or simply “envelope wage” (Colin, 2009). According to the author all countries, sectors, and population groups participate to some extent in hidden work.

Related to the issues of the hidden economies Sookram and Watson (2008) have investigated the informal sector of an emerging economy. They have found that small businesses are motivated to participate in the informal sector because they believe that the risk of detection by the tax authorities is low (Sookram and Watson, 2008). In the literature it has been argued that informal activities that these countries are characterized tends to be applied in the sectors of economy that are low-skilled and low-wage jobs and also where it is easy to employ and pay workers without registration or documentation (Sookram and Watson, 2008) as Colin (2009) called 'envelope wage'. This leads us to assume that individuals with lower income tend to be more active in the informal sector (Sookram and Watson, 2008).

3.7.1 Transition and Financial Architecture

An excellent article written by Berglof and Bolton in 2002 describes the financial system of transition countries where the centralized financial system evolved into a decentralized system of market economy. They claim that this process was followed by the separation of the central bank and commercial bank activities establishing a two-tier banking system which additionally was supported by the process of mass privatization. Following these developments they argue that financing activities are bank based, that is, banks are playing an important role in providing financial injections to the entities.

On the other hand, the inappropriate and slow process of privatization has not motivated the development of equity markets where they appear to be volatile and susceptible to internal trading and other devastating activities (Berglof and Bolton, 2002). Speaking in the accounting language, these countries are mainly based on banks as finance providers, they belong to the continental model or code-law group because of the need of creditor protection since there is a weak equity market, that is, accounting rules will tend to be oriented towards creditor protection. In addition most of these countries have created a code-law institutional model to have more incentives in being a part of the

EU and facilitate their potential membership to join the EU (Berglof and Bolton, 2002). Although authors claim that enforcement of the rules is perceived weak in these countries and there is much to do to change this perception.

3.7.2 Accounting Features in Transitional Economies

As mentioned in the previous sections, privatization has caused significant changes in the development towards a market economy. Prior to that, state-controlled entities were the main drivers of the economy providing revenues for the state. Therefore accounting systems in command economies were used to record the activities of the entities controlled by the state in monetary terms (Bailey, 1995) that is cash accounting. Bailey claims that accounting was used as a control instrument with administrative peculiarities, especially in keeping an eye on state entities and with the intention of achieving what was planned, where the commercial notions were not rated at all and no public accountability was taken into consideration.

As the transition process started to seed its main notions into these countries, the nature of the accounting also changed. Bailey explains the paradoxical issue of how change in accounting was initiated by the state emphasising the “formal” compliance with the accounting rules, because of the underdeveloped market economy, accounting is still driven by the state as a tool for collecting the state revenues. For this reason, “In many economies in the CEE, as the way in which some of the revenues for the state budget are levied have changed (from direct appropriation of revenues from state enterprises to the levying of taxes on private and state enterprises) the power of the tax inspectorate has grown” (Sucher *et al.* 2008, p.573). Sucher *et al.* further argues that, in general, there is a lack of an accounting profession because of the lack of efficient markets. In this line of reasoning, accounting development will depend on the development of the efficient market economy and liberalization.

3.7.3 Some Empirical Studies in Transition Economies

In international accounting literature, accounting is influenced by the environmental forces that might influence accounting which may be economic, social, legal, cultural and political. Zeghal and Mhedhbi (2006) have identified factors that effect the adoption of international accounting standards by developing and transition countries, namely: economic growth, education level, degree of economic openness, culture, and the existence of a capital market. As a result, they argue that with the internationalization of economic trade, globalization of businesses and the development of financial markets, the domestic accounting system will not satisfy the users' need, therefore domestic information will lead to missed opportunities for businesses and investors. They note the importance of the process of harmonized accounting standards and practices as a fundamental change in recent years, providing national and international decision makers with homogeneous information that is comparable and reliable (Zeghal and Mhedhbi, 2006).

The factors mentioned above have a significant effect and simultaneously having a contrary effect in the adoption of international accounting standards as described in Nobes' model. Globalized business and economic activities need a high-quality accounting system and standards to respond to the demands of a dynamic business environment; therefore applying these standards necessarily implies a high level of education, which could be a barrier in countries with low and weak expertise to the adoption of these standards. Diversity of the culture in developing and transition countries has been a major factor in the choice of an accounting system. As it is known IASB is characterized by the Anglo-Saxon approach and, as a consequence, the "language" of the standards will be a barrier for developing countries that differ from the Anglo-Saxon culture. The two factors, economic openness and the existence of a capital markets, will lead to a higher degree of adoption of international accounting standards (Zeghal and Mhedhbi, 2006).

An example that can explain the challengeable adoption of international standards in transition economies is the empirical study made by Lapters and Popa (2009) for Romanian accounting. They have found that the application of the IFRS for SMEs in Romania is not welcomed because the Romanian professional accountants are not yet ready to accept the IFRS philosophy based on professional reasoning for finding the best solution in solving the accounting problems. To prove the statements above, Romanian accounting is negligent to accept and adopt international standards because of difficulties in accepting the idea to make the transition from one accounting model to another one. Other reasons might be: relationship of taxation and accounting, that is, they have been used to provide information to one single user which is the state and secondly, the accounting professionals are unable to estimate the main benefits of implementing the IAS/IFRS in Romanian accounting (Lapters and Popa, 2009).

We have taken Romanian accounting as an example but the challenges and difficulties adopting international standards are very common in many of European and non-European countries, especially the countries that are part of developing and transition economies in Central and Eastern Europe.

In these countries, transformation from a rigid centralized economy into an emerging market economy has been very painful. This leads to reflect that all spheres were affected such as economy, politics, culture, education and so on (Preobragenskaya and McGee, 2004). The reform process is taking place towards IFRS in transition economies, in order to fulfill the requirements and become member states of the EU.

In order to understand the transition process and the reform process in these countries, it is important to know the functions of accounting in the planned centralized economy because the whole process (transition and reforms) is related to these issues. One of the major functions was to collect statistical information that formed the basis for control and a secondary function was the safety and controlling of assets that belonged to the state (Preobragenskaya and McGee, 2004). The process of reforming the accounting system has been going on for a long time in Central and Eastern Europe. The authors have also investigated the transition to IFRS in Russia.

According to Preobragenskaya and McGee (2004) problems that this country has faced in making the transition from Russian accounting standards to IFRS is the 'lack of demand' by accountants and businesses. They do not see the need for IFRS because of the utilization of financial information to the company management. Another problem is the necessity of legislative changes not only in accounting but also tax and in civil laws. Changes are needed because of the differences in definitions, terms and concepts (ex. market price). Authors have found that the level of economic development, lack of accounting professionals and lack of consultants can be seen as problems towards IFRS by transition economies.

As mentioned earlier the SME sector is the healthier and most profitable sector in transition economies, therefore any reform in accounting rules could affect these entities. Hence, we are interested to investigate whether proposed IFRS for SMEs, and the possible changes in accounting regulation would be suitable for the entities in transition countries with the emphasis in Macedonia.

4. Empirical Data and Analysis

This chapter will present the most relevant empirical findings that we gathered from our conducted interviews. This chapter aims to clarify the respondents' perceptions and opinions in order to give a view of the field. We aim to address the research questions and thereby the purpose of this thesis. This is realized by a discussion based on our empirical findings.

4.1 Empirical Data Presentation

As stated in chapter two, we have taken a qualitative approach and conducted interviews in order to relate to our subject the views of respondents and what is relevant according to them. Empirical data presents the individual viewpoint of each respondent. Therefore, we were flexible and reflected the interviewees concerns in our subject to justify and interpret the empirical data to our analysis.

We have divided the primary sources into four different categories that will represent four different perspectives in investigating the suitability of IFRS for SMEs and financial reporting of these entities. We have also contacted three banks in order to add a user perspective, but we have not received a positive answer from them, responding only to say that they were unaware of the IFRS for SMEs issue and adding that they have their own models in evaluating an entity's financial situation. Our respondents are as follows:

- University Academics/lecturers of accounting
- Accounting practitioners-professionals
- Ministry of Finance- accounting regulatory body

- Consulting firm-the accounting rules transmitter

In order to receive a general view to our topic, respondents were given brief explanations that facilitated them in answering our questions. Furthermore, we have sent the interview questions in advance to our respondents. Even though there are different respondents, the questions forms were designed same among each respondent. Since the interviews were semi-structured we have also asked additional questions where necessary. This is because each respondent will contribute with different knowledge and experience to our interest area and help us to answer our research question, and fulfill our thesis purpose. So, in total we have conducted 8 interviews: three from academics, three from practitioners, one interview from the Ministry of Finance, and one interview with a consulting firm.

4.1.2 Background of the Interviewees

Academics

We have contacted 9 academics where we received three positive answers from them. They are Dr. Abdylmenaf Bexheti a Pro-Rector for Financial Planning at a university. He has experience in accounting, and also taken place in drafting accounting regulations. The second is Dr. Sotiraq Dhamo. He is a head of Accounting Department at a university, and very experienced in accounting. His field is international standards and their issues. He has also taken place in drafting accounting regulations. Third is Mr. Fitim Deari, MSc, a senior assistant at a university, department of accounting. He has been involved in several international accounting research projects dealing with the issues of Macedonian accounting standards.

Practitioners

The second target of our interviewees is accounting practitioners. In total we have contacted 11 accounting practitioners, but we only received 2 positive answers from them. The two respondents are very experienced in accounting and auditing as well. Here

we have put also the Big 4 respondent as accounting practitioner. So, in total we have 3 positive answers from practitioners.

“Bend revizija I konsulting” Tetovo is private auditing, accounting and consulting firm. It was established in 1998 and the chairman of the firm is Mr. Dushko Apostollovski which is also an authorized auditor in Macedonia. "DIMITROV REVIZIJA" Skopje is registered Audit Firm in the Republic of Macedonia from 2003. The interviewee of this private auditing firm is Zvonko Kocovski-a partner of this firm. He is a certified auditor with permanent certificate. He works on accounting matters, taxes and other consulting services and since 1999 he is actively engaged in accounting and auditing. This firm has participated in translation of the International Accounting Standards from English to Macedonian language for the first time in 1997 with approval of former IASC (International Accounting Standards Committee) in London.

Moreover a Big 4 firm was the most important respondent to us since it will add validity to our thesis, where we received a positive answer only from one of them which we will call the “Big 4” respondent since they wanted to remain anonymous.

Ministry of Finance-Accounting Regulatory Body

Our interview in the Ministry of Finance was with two persons simultaneously. They were Ms. Lence Tagasovska the Head of the Finance System Department and with Ms. Aleksandra Dimovska the Head of Accounting Sector which is operating under the Finance System Department.

Consulting firm-the accounting rules transmitter

We have contacted two consulting firms that transmit and interpret accounting/bookkeeping rules. We have received one positive answer. That is “FV consulting” with the owner Ms. Trendafilka Vasileva and Ms. Kostadinka Georgievska. We have conducted the interview with them together.

4.2 Data analysis and Discussion

This section represents and goes over the main points of the respondents answers. All the respondents were aware of the IFRS for SME issue, or taking part in translating, using and interpreting the standards. Here, we present the respondents opinions with the attachment of the quotes so as to show what was said by them.

All of our 8 respondents agreed that IFRS for SMEs would be appropriate for Macedonian non-listed entities. We have asked them whether IFRS for SMEs should be adopted by the Ministry of Finance, as one of the academics said:

“Yes, definitely, it should be done even earlier. It is necessary that accounting sector as a part of Ministry of Finance which is governed by the head of the sector should develop an accounting system on the basis of these concepts.”

This answer was also supported by other respondents pointing out other issues, such as of effectiveness and simplicity. For example an authorized auditor responded:

“Yes. First of all, small entities don’t need all the standards. Since I deal with small and medium entities, this set of IFRS for SMEs will help me a lot, so I effectively conduct the audit. As Macedonia’s financial market is not too developed, financial instruments are in a small amount, so SMEs are probably more than 95% in total, they will be a part of this approach for sure.”

However two of our academic respondents think that the IFRS for SMEs adoption would be a challenge primarily for the management and for the accountants of these entities. They think that accountants will not be prepared to face these changes, so there is going to be resistance to changes, therefore they are not easy to be implemented because of their complexity. While another academic, gave an interesting comment while answering the suitability question:

“I believe that we should adopt IFRS for SMEs in our country. This is because we can provide faithful and qualitative information of financial reports and also to foster infusion of foreign investments...”

Costs and Benefits in applying IFRS for SMEs

Since the globalization of trade and the increase of foreign investments has been apparent in the last years, there is a necessity of comparable financial reports by the all entities in a country. Therefore, there is a need for consistency in presenting consistent reporting. However, as Nobes discusses, divergences still exist in accounting practices. All of our respondents agreed that benefits would exceed cost in acceptance of IFRS for SMEs. While analyzing our interviews, we had similar answers regarding the benefits, if our country applies IFRS for SMEs. Here we present points of the benefits that are mentioned by the respondents:

- Universality
- Uniformity of the financial statements
- Increase of the quality of the financial information
- Increase of the reliability of the information
- Growth in transparency in the terms of the economic and financial situation
- Attracting foreign investors because of the consistency of standards
- Low cost of information asymmetry
- Increase of accounting information credibility
- Producing information that will be relevant to decision making

Besides the benefits, according to our respondents (except the respondent of the Ministry of Finance answered that there will not be costs), the costs would be:

- Translation of the standards
- Staff education, the cost of training
- Cost of different reporting (if IFRS for SMEs is an option for SMEs)

The respondents of the Ministry of Finance were a special case. They said there will not be costs when IFRS for SMEs will be applied, since they are simpler, and encompass fewer loads than the full IFRS, which are currently used.

4.2.1 Current Accounting Rules and Accounting Regulation for SMEs in Macedonia

Ministry of Finance comments on IFRS and IFRS for SMEs

From our respondents we have found out that Macedonia uses full IFRS and establishes National Accounting Standards to non-listed that are directly derived from the IFRS principles. Listed entities are obliged to use full IFRS, non-listed use national standards derived from full IFRS, but they have an option to use it if necessary. That is, the Trade Company Law regulates the accounting in Macedonia which is set or drafted by the Ministry of Finance. Afterwards the regulation is published in Official Gazette. Moreover the absence of a national accounting standards-setter pushes the acceptance of IFRS for SMEs. Most of answers received by the Ministry of Finance Accounting Sector representatives were “According to Trade Company Law...”, and not with the problems, critics and the accounting issues of SMEs.

“I can say, we are implementing the full set of IFRS now...I mean according to the Trade Company Law it is mandatory for all listed entities, and also an option for others. In 2010 with the changes in the company law, so the set of full IFRS are going to be used by listed entities, financial institutions, banks, insurance companies. We are now in the process of translation of IFRS for SMEs and we expect until the end of this month, or eventually the next one, they are going to be published in the Official Gazette... I think that from 2012 they should be implemented because it is more acceptable to SMEs, there would be less load than full IFRS, so there are fewer requirements. This is a positive approach, taking into consideration that there is no national standard-setter, there are no national accounting standards and acceptance of these standards is going to be easier to us. So until now, IFRS are used, we don't have national standards, so the standards that are used for non-listed entities are based on full IFRS”

As we can see, accounting regulation in Macedonia is directly driven and determined by the Ministry of Finance, which also collects taxes. Furthermore this is against the notion of the IFRS and takes into consideration the users needs such as investors, creditors, and other stakeholders except the state. This also illustrates the strong link of accounting and taxation where the tax rules are the accounting rules as well, as Nobes demonstrated the case in Germany. Based on the above statements our respondents from the Ministry of Finance give their knowledge on that:

“The Ministry of Finance regulates... so it is responsible to regulate accounting through Company Trade Law. This law states who is responsible to compile the financial statements, according to which standards, which are the elements that annual accounts should contain, how the profit is distributed, how the losses are covered, in short, all these standards are covered in Company Trade Law. Based on this, the Finance Minister creates regulation which contains the full IFRS, which is the translated form, originally from the IASB, only the core standards and not the extra examples (interpretations). So, the core standards are a pure translation from English, and all entities have the right to use it in conducting accounting.”

Novelty with IFRS for SMEs

According to Company Law SMEs must prepare annual accounts which include a balance sheet, income statement, and some special notes that have to do with the income from their main activity, and a tax form if that is necessary that is, if the entity has non-productive/non-functional expenses (since there is no income tax, these expenses are taxed), and they have to be submitted to the Central Registry. Some of our respondents emphasized the novelty that will be notes to the financial accounts of the SMEs.

“The novelty will be notes to the financial accounts of the SMEs, which in the beginning could cause difficulties for filling and completing the financial reports. Since SMEs for the first time will be in touch with the notes, there is going to be education (trainings and seminars) about this issue...but notes would help users a lot.”

4.2.2 Current Problems and Difficulties in applying IFRS

Translation and Understandability problems

We have asked our respondents about the problems that SMEs face in financial reporting. Respondent from the Ministry of Finance replied that there are no problems regarding the standards, however the right translation of the standards was the problem that we detected from the interview. Additionally, this issue was also raised by “FV consulting”:

“Firstly, bad translation of the standards, they are too long, which is hard to understand...also different terminology or the absence of it... we don’t even understand the translation! There should be practical examples attached to standards!”

This issue is contradictory between the regulatory body and those who practice the IFRS, since the comment from the Ministry was that there is no problem except the translation.

State policy avoiding the originality of the standards

Although, the implementation of the international accounting standards is a dominant debate in accounting matters in Macedonia, there are concerns of escaping from that. From 2011 there is no income tax applied. We have asked our respondent FV Consulting whether this issue is according to IAS12. The answer that we received was that, this is more a state policy choice, and has not to do with the standards.

“No it is not according to standards, it is a purely our regulation, a policy. So, IAS12 does not fit to our regulation. Earlier, income was taxed, and now non-productive/non-functional expenses are taxed annually. We do not understand this standard too. Maybe auditors do. The crucial role here is played by the state-taxes. For example deferred tax is a concept that is not in accounting plan. We do not record deferred taxes at all. Additionally there are few questions about IAS12.”

Problems in accounting practices

However, other problems were detected in our interviews. Respondents gave us various and interesting comments. The greatest difficulty is the difference between the concept of economic category of an entity and the concept of the state in collecting taxes. Owners, managers and accountants are instead state stakeholders. The state collects the data through the annual reports for fiscal and macro statistical purposes. Our respondents gave us these comments:

“The state is strongly connected to accounting because of the taxes.”

“Instead of owners, managers etc, there is the state as a single stakeholder, not only in the fiscal aspect but also for macro statistical purposes.”

Additionally, we asked our respondents the reasons why this strong connection exists. One of them gave us this interesting comment:

“...I can mention the issue of assuring the tax income (by the state) because we are economically weak countries...unfamiliarity with the international accounting standards from the tax organs and also from the accountants...”

The respondents also raised the concern regarding the opportunities in the system where there are options in the law for different practices, for example the concept of depreciation. The respondent gave us this example:

“...take the depreciation category, the depreciation rate is set by the law, with the depreciation nomenclature (catalog), but there is an option where you can over depreciate the value, and in fact the depreciation value in your accounts could be something else but a real value of an asset, for instance...so the financial accounts do not represent reality at 100%, but someone (Ministry of Finance) processes them for macro statistical purposes, in the sense of setting macroeconomic plans and in the sense of economic development. Can you imagine that? ”

4.3 Accounting Quality and Importance of Accounting

In Chapter three we have described two accounting models presented by Nobes. These are broadly known as the Continental group and the Anglo-Saxon group of countries. The model, to some extent, also describes the concept of a good accounting standard in the group perception. Additionally, we can say that the quality of accounting differs from country to country. There are no strict judgments which are the best standards according to the two principles, the rule based or principle based accounting dichotomy, but when generalizing what is an accounting quality there are many factors that can have influence as Soderstrom and Sun (2007) pointed out the factors such as accounting standards, political system, and tax system. While analyzing our data, we have noticed and seen reasonable to attach the accounting profession as a factor influencing the accounting quality. There is a great possibility that this factor could affect accounting quality.

Accounting standards and political system

Soderstrom and Sun argue that accounting standards and a political system can spontaneously influence the accounting system and the accounting quality as well. A political system is more oriented in decreasing volatility towards the entity's stakeholders. Based on IFRS for SMEs some assets and liabilities are to be measured by the fair value as an appropriate concept. However Macedonian accounting rules stick to historical cost accounting. The aspect of fair value was pointed out and criticized by our certified auditor:

“The world crisis is changing the concept. Now is the question of the concept, if the accounting principles should go back to historical cost, as a closer concept to reality. ”

Another respondent gave us a critical comment regarding the current accounting standards and the political system experienced in the country:

“The purpose of the financial information as a conceptual definition is broadly known...but it is a question mark if it is in a function of commercial decision making policy of the entity... in fact is not. As it is functioning now, it is (accounting) more in the function of the state demands, so it is an imposition rather than a need.”

Tax system

Soderstrom and Sun discuss several ways how tax system affects accounting quality. They claim that a close connection of accounting and taxes reduces the accounting quality and also the quality of accounting standards. One of the respondents even mentioned the bureaucratization of the accounting system.

“...there is unfortunately a strong connection...this means bureaucratization of the accounting system...the Ministry of Finance should weaken this link...this is because taxation has other objectives in one hand, and financial reporting has other objectives on the other hand.”

An important aspect that Soderstrom and Sun discuss is that of the tax rate. They conclude the higher the tax rate, the higher the motivation to hide profits. Additionally the tax rate is determined by the political process as well. In Macedonia, as we mentioned earlier, there is no income tax. For this issue one of our respondents stated that:

“...there is a decreasing tendency...because of the decreasing tax burden...but the risk cost (detection cost) is higher to abuse or hide the income...”

Accounting profession

As we have elaborated in Chapter 3 the accounting profession is seen as a cause that is influencing the both models of the Continental and the Anglo-Saxon group of countries. In the Continental group the professions' size, competence and strength is lower. Therefore it is perceived that the profession is weak because of the close connection of accounting and taxes. The larger corpus of tax experts is evident on this group. On the other group, the Anglo-Saxon, professions' size, competence and strength is higher, because of the larger capital markets. The necessity of accountants and auditors is apparent rather than tax experts (Nobes and Parker, 2008).

However, in Macedonia, it is a big question mark if the accounting profession exists, in terms of the certification of the accounting practitioners. During our interviews with our respondents for this issue, they were very convinced that the accounting

profession has shortcomings in terms of certification, and the determination of who should practice accounting. In this case, all our interviewees blamed the state that neglected regulating this issue. A respondent commented on the question of the profession:

“In fact, we have to regret that the accounting profession is the most degraded profession at the moment, since it is not protected by law. It should be stated in law, who can exercise accounting...I think we have left a gap here!”

Additionally accounting is perceived as a craft that is exercised by everyone and over commercialized on its' roots. Another respondent that was asked about the profession answered:

“We don't have certified accountants. I think the state has left a black hole here! A certification would determine someone trained, well educated who has 'passed the exam'...I can say in Macedonia everyone who possesses the skill could exercise accounting. I think the state has to regulate this as soon as possible.”

Even the Ministry of Finance respondents did not know the reason of this problem, when we asked them how many accountants are there in Macedonia:

“That is the problem, we don't know yet, we will know that when the accounting profession is regulated...so we have been focused in auditing only...but it will be. It will be a registry where the accountants will be registered...but setting a regulation to this issue, is like a double edged sword, to those who until now worked as accountants...so some of them will be unemployed, so there is a doubt if there is a need to regulate it. The state should decide on this!”

4.4 Users of Financial Reporting of SMEs

While reviewing the literature, the research implies that the users of financial reporting of SMEs are generally owners, banks and the state. The state via tax authorities uses the information for the purposes mainly in collecting taxes; owners need the information

mainly to facilitate the decision making process and banks as a user to check the ability of the entity to repay their debts. In line with Son *et al.* (2006) study, our research results indicate that the state is appeared to be the dominant user. Additionally our research proves that other users such as owners and banks are under valuated. A respondent gave this comment:

“...the information is not systematized in that level to generate accounting information for decision making...that is, the information does not directly help the managers/owners of SMEs. Still SMEs encompass the so-called fulfilling the norms generated by the system.”

However with the changes in 2012, with attaching the notes to the financial reports of the SMEs, there would be incentives in fulfilling the other information needs demanded by the banks (and probably other users), as the largest finance provider to SMEs. A respondent gave us this comment:

“...at the moment the main user is the state...banks also demand detailed information...but notes would help them a lot. If you look at the numbers of the balance sheet, you don't see the background of it, and I think banks now require more than a regulator...”

5. Conclusion

In this chapter we will present the conclusions of our study. We start by discussing the results of our analysis and make our own judgments for the results.

The agenda of IFRS for SMEs has caused a long debate among many countries whether they should be adopted or left the issue to the jurisdictions of the each country. However, revolutionizing the reporting by the SMEs would be a challenge for every country, especially for the transition countries, such as Macedonia. Moreover, the accounting system in the transition countries is moving towards IFRS, to gain access into international markets, but again having the traces of the old system where the state persists to shape the accounting notion (Bailey, 1995).

Our thesis analyzed the appropriateness of the IFRS for SMEs in Macedonia. This study found that since Macedonia derives the accounting regulation from the full IFRS, this will facilitate and easier acceptance of IFRS for SMEs. Since IFRS for SMEs is the abbreviation of full IFRS, the similarity would help smooth the progress. These standards are now in the process of translation and 2012 will be the year of its implementation. The novelty will be the application of the notes to the financial reports of the SMEs. However the fair value will be neglected as a concept since the regulation is stuck to the historical cost. Our results furthermore show that benefits would exceed the costs.

During our thesis we established a general picture of the accounting system in Macedonia. On the one hand, the Ministry of Finance-Accounting Sector is the ultimate body that sets up the accounting regulation. On the other hand, consulting firms interpret and transmit this regulation via seminars and lectures to the accounting practitioners. The characteristic of the Macedonia accounting regulation is the accounting plan, which is similar to French accounting regulation. The accounting plan is divided into 10 classes (from 0 to 9). These classes represent detailed and analytical accounting topics and it is

used in recording transactions, compiling financial reports and tax purposes. In appendix 2 the accounting classes are presented.

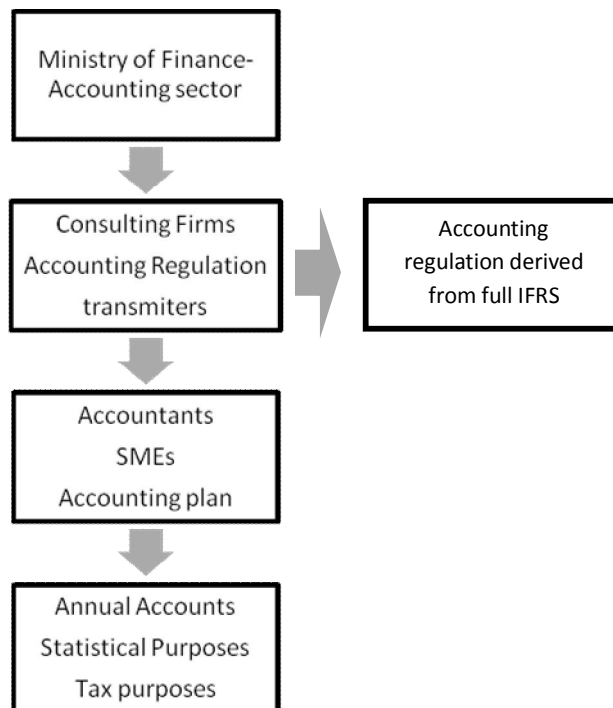


Figure 1. Accounting regulation for SMEs in Macedonia

It must be noted that even Macedonia uses full IFRS, in fact it derives the accounting rules from these standards, however, still there are differences in accounting practices. Translation and understandability was pointed out by our respondents as problems in using IFRS. Besides this, there is also escape from the IAS notions. For example we have found that IAS12 (income taxes) is not applied, in fact, there are no

income taxes at all in the country. Our results show that the state policy on taxes has avoided originality of this standard.

The prevalence of the accounting models presented by Nobes, determine the accounting quality and importance of accounting perceived in countries of each model. Based on Soderstrom and Sun (2007) study, accounting quality is influenced or driven by factors such as accounting standards, the political system, and the tax system. While studying our empirical data we have also put the accounting profession as a factor that influences accounting quality. Our results indicate that political system and tax system influence each other; additionally both of them influence the accounting standard, which as a result, influences accounting quality. Furthermore, the tax system, respectively the close connection of accounting and taxes influences the accounting profession. Moreover, the accounting profession influences the accounting quality. Our results show that the accounting profession is the weakest link in the circle which makes the accounting quality poor. Due to the weak profession, accounting information may even lack trustworthiness. Additionally, most of the financial information presented is influenced by the owners, and because of the close tax-accounting link owners have an adverse view on the role of accounting as Son *et al* (2006) argue in their study.

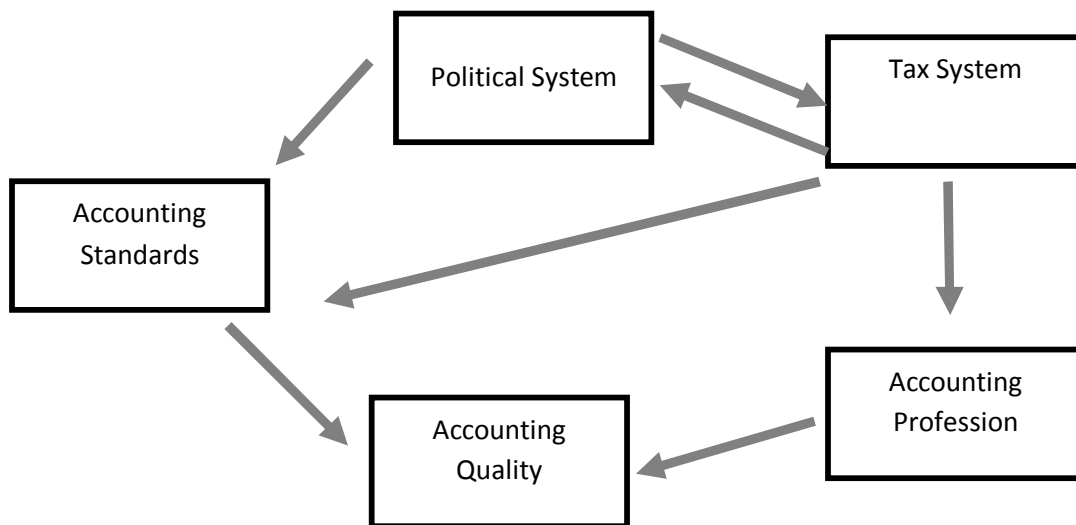


Figure 2. Factors influencing accounting quality

Our study concludes that, the implementation of IFRS for SMEs will increase the accounting quality and it would be interesting to witness what lies ahead, but always recalling that this is going to be a challengeable process with much difficulty. However, this process would also facilitate SMEs to provide more reliable information and as Son *et al.* (2006) state, to be proactive to the user needs. The state will also play an important role here. Our results indicate that state is the main user of the SMEs financial reports. The IFRS for SMEs, optimistically, will bring changes and make these entities adapt and grow in the environment that is constantly changing in a transition economy of Macedonia.

6. Suggestions for Further Research

In this terminative chapter, we will recommend further research. While writing the theoretical frame of reference and the analysis, different questions occurred that we found to be interesting to further study. Hence, these thoughts are briefly described in the following section.

Our study was oriented towards the appropriateness of the IFRS for SMEs in Macedonia; these standards are to be implemented in 2012. We believe that the suitability of these standards is to be explored in 2012, and results may be useful after their implementation especially regarding the users perceptions about the financial information presented by SMEs. A future study could also focus on the size of SMEs in Macedonia, additionally if the size of the entity would be an advantage or disadvantage in using IFRS for SMEs, since these standards will be used by all the entities except listed ones. One could also investigate what problems may arise during the implementation, for example in several accounting topics.

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Appendix 1

Interview questions

1. How relevant is accounting for SMEs in Macedonia?
2. What do you think about the quality of financial information with the present accounting regulation?
3. Which are the accounting standards used in Macedonia? Where the difficulties and problems exist? Why?
4. Is there a need for different financial reporting for SMEs compared to the listed ones? Why?
5. Who are the main users of financial reports of the SMEs?
6. Are the current rules consistent with the users need?
7. Which are the difficulties that SMEs face in financial reporting with present accounting regulation?
8. What do you think about the tax-accounting connection in Macedonia? Do you think it moves towards a weaker or stronger connection? Why?
9. Would IFRS for SMEs be adopted by the Ministry of Finance?
10. How is the accounting education and the profession developed in Macedonia? Why?
11. Would the profession/education facilitate the IFRS for SMEs adoption?
12. Do you think that there is something else to be considered regarding the accounting regulation in Macedonia?

Appendix 2

Macedonian Accounting Plan

Class 0 Permanent Assets-Tangible, Intangible, Goodwill

Class 1 Money, Securities, Short Term Receivables

Class 2 Debts, Reserves

Class 3 Inventory

Class 4 Expenses, Costs

Class 5 Free (for entity's purposes)

Class 6 Stocks, Goods ready to be sold

Class 7 Revenues and Expenditure

Class 8 (Accounting) Result from the Activity (profit or loss)

Class 9 Capital and Capital Reserves