International Review of Business Research Papers
Vol.4 No.1 January 2008 Pp.223-232

Shortened IFRS Standards – Do they Benefit to the Harmonisation of Accounting? The Estonian Case

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The EU Regulation on harmonisation of accounting in the European Union has been effective for 5 years and the second year has passed when every public company has been obliged to report in compliance with IFRS. Growing number of countries including Estonia has selected IFRS as a founding framework for its own local accounting guidelines. Though those guidelines are declared to be compliant with IFRS accounting principles differences remain. The current article analyses the causes of known differences: decisions made by the standard-setter to have different approach; differences caused by the shortening of text and differences caused by the translation.

Field of research: transition economy, accounting, harmonization

1. How to understand 'harmonisation' and previous research in this area

Harmonisation of accounting in the international literature is treated using three distinct concepts: harmonisation, standardisation and normalisation. In general, standardisation and normalisation are used in connection with minimising choices in accounting approach while harmonisation is used more in connection with comparability of accounts. Although discussions of harmonisation of accounting are widespread, harmonisation itself does not be a clear term. We can find different definitions of harmonisation of accounting in the literature. According to Fredrick Choi (1999), harmonisation is a process of increasing the compatibility of accounting practices by setting limits on how much they can vary and standardization means the imposition of a rigid and narrow set of rules, and even a single standard or rule may be applied in all situations (Choi 1999). On the basis of this definition, harmonisation of standards will minimise logical conflicts and improve the comparability of financial information from different countries.

From newer literature, Tom Rolfe defines the harmonisation of accounting as the process of increasing compatibility of accounting practices by setting bounds to their degree of variation (Rolf, 2005).

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Harmonisation of accounting standards requires that cross-national rules be brought in line with each other or with an international standard setting body regulations.

The European Commission has stressed that the harmonisation pursued through implementation of the directives does not necessarily mean uniformity. Rather, the objective is the comparability and equivalence of financial information (Commission of the European Communities 1995; also Van Hulle, 1993: 99). The existence of de facto harmonisation process in practice combined with strong political pressure from globally acting companies which wanted to avoid the inefficiencies of establishing more than one set of statements, have urged regulatory bodies on a national level to react in order to achieve a *de jure* harmony, not only on the European level any more but on international level as well (Simga-Mugan, Hosal-Akman, 2005).

As a result of harmonisation, the financial statements of enterprises will contain more reliable, comparable and transparent financial information, necessary for the efficient functioning of the stock markets, banks and investment.

Authors of this article are using term ‘harmonisation’ with a transaction-based meaning that whenever one talk about harmonisation of accounting it is about the expectation that similar companies report similar transactions in the same way, resulting in a uniform disclosure of assets, liabilities, cash flows and the result of the period.

Studies in the area of harmonisation have been either country driven or have a mixed approach. McLeay and Jaafar (2003) have analysed accounting approaches selected by listed European companies (EU15) to determine whether the country or industry is a determinant factor for selecting an accounting policy for areas with different alternatives (McLeavy and Jaafar, 2003). They conclude that the country of domicile and sector of operations are each significant determinants of selecting accounting policy across Europe, whereas country differences appear to be far greater than sector differences.

Reasons why national GAAP differs from IFRS have been analysed by Ding, Jeanjean and Stolowy (2004). Their research supported Gray’s paper from 1988 about cultural phenomena in accounting and based on data of 52 countries there are links between Hofstede’s cultural dimensions and divergence from IAS. They identified two causes for differences: divergence (both national GAAP and IAS cover a specific accounting topic but prescribe different methods) and absence (national GAAP does not cover accounting topic in IAS).

We can see later that the absence can be bipartite and there are accounting topics that are not within scope of the current set of IFRS or in the agenda of the IASB. No research has been performed on the language differences, where the term in English can not be translated into local language without changing its

meaning. Based on authors' personal experience such situations are possible, at least in translation into Estonian.

2. Setting benchmark to determine whish difference is important and which is not

When talking about harmonisation and comparability one need to determine what differences are of such importance that we can talk about incomparable accounting.

IFRS defines materiality through the economic decisions of the users of financial statements. Information is material when its omission or misstatement can influence economic decisions (IFRS Framework). Using the same rationale is practicable in the research. Difference in accounting approach will be classified as a major one when it results in substantially different values or presentation of the assets, liabilities, owners' equity, or result of the period. All those can probably cause different economic decision of users.

3. The Estonian case

Estonia, due to its minuscule size and lack of resource has pioneered harmonisation of local financial accounting with the IFRSs to avoid costs of developing its own set of high-quality financial reporting standards.

Before regaining independence in 1991, the accounting in Estonia was regulated by the Soviet Union guidelines and rules. The Soviet accounting system gave strict rules up to the level of an accounting entry in some cases and was based on state plans for the economy. The main aim was unification of accounting and the possibility to control economic activities of all companies and compare them with the state plans. After regaining independence in 1991, the Estonian Ministry of Finance approved the first accounting guidelines in 1993 and the first Estonian Accounting Law was approved by the Parliament on 8 June 1994.

The first Estonian Accounting Law (EAL) did not provide specific rules for the Accounting Standards Board and during the late 1990s; this allowed a private company to publish the standards. Because some standards were only published by a private company they did not have any legal effect as they were not published properly. The major difference compared to EU regulations was that until 2002 Estonian groups of companies (except for listed companies and financial institutions) were not obliged to present consolidated annual reports. This fact was emphasised during the pre-accession negotiations by the European Union as an item what needed harmonisation before joining the EU.

Estonian Accounting Law was rewritten in 2003, when the Estonian Accounting Standards Board decided to support more clearly use of IFRS-s in Estonia. Since

then each Estonian company can choose IFRS also for its statutory reporting and does not need to prepare the second set of financial statements when one set of IFRS compliant financial statements has already been prepared. Also, EASB made an attempt to create a set of “simplified” IFRS standards for use by smaller companies.

4. Comparison of Estonian Accounting Standards and IFRSs

Estonian Accounting Standards Board decided in 2003 that Estonian Accounting Standards have to be in compliance with IFRSs with the exception of a small number of cases where alternative accounting treatments are not allowed. However, to be more straightforward, these guidelines are shortened and include several IASs and IFRSs. Concordance between the standards is provided in the Table 1.What is the degree of real harmonisation of accounting between IFRS and EAS? To answer that question, a comparison of these two frameworks was performed with the aim of detecting significant differences. The result of the comparison is presented in the Table 2-1 to 2-4.

The comparison demonstrates that while EAS includes 18 standards, IFRS had 37 published standards as of 1 January 2007, from which IFRS 8 will be valid only for the periods starting in 2009. There are 3 EAS-s that relate to the topics not covered by IFRS and 5 IFRS-s not included in EAS. We can eliminate some of these omissions due to specific features of the Estonian economy like absence of corporate income tax what eliminates possibility of timing differences of tax cash flows; or the requirement that all financial institutions have to present their financial statements in accordance with IFRS, making the IAS 30 not applicable for statutory purposes. After the elimination of these differences we can see that there are substantial differences in applicable accounting policies in 7 EAS-s, which is half of the corresponding standards taking into account that EAS 0 and 1 are generally considered to be one standard. These differences will result in most cases in a substantially different classification of items in the balance sheet and income statement, different value of net assets or in different result for the period. All these are important factors for the decision-making and therefore it is demonstrated that there are important differences that result in incomparable financial information.

5. The causes of differences

If the different approach in the accounting methods is chosen by EASB, the comments on each EAS include reasons for taking the approach. There are areas where EASB has decided to take a simplified approach in cases where the different approach in prevalent number of cases results in an immaterial difference or when the practice is not widespread in Estonia.

Table 1. Relationship of the Estonian Accounting Standards and the IFRS

Standard number	Estonian Accounting Standard title	Relation to the IFRS	
		Before 2005	2005 and later
EAS 0 and 1	Framework for the Preparation and Presentation of Financial Statements	IAS Framework (partly)	IAS Framework (partly), IAS 1
EAS 2	Presentation of Financial Statements	IAS 1, 7	IAS 1, 7, 8
EAS 3	Financial Instruments	IAS 39	IAS 39, 32
EAS 4	Inventories	IAS 2	IAS 2
EAS 5	Property, plant, equipment and Intangible assets	IAS 16, 38, 36, 23	IAS 16, 38, 23, IFRS 5
EAS 6	Investment properties	IAS 40	IAS 40
EAS 7	Agriculture	IAS 41	IAS 41
EAS 8	Provisions, Contingent Liabilities and Contingent Assets	IAS 37	IAS 37
EAS 9	Leases	IAS 17	IAS 17
EAS 10	Revenue	IAS 18, 11	IAS 18, 11
EAS 11	Business Combinations, Consolidated Financial Statements and Accounting for Investments in Subsidiaries	IAS 22, 27, 28, 21	IFRS 3, IAS 27, 28, 21
EAS 12	Accounting for Government Grants and Disclosure for Government Assistance	IAS 20, 41	IAS 20,41
EAS 13	Closing Balance Sheet	Not covered by IFRS	Not covered by IFRS
EAS 14	Accounting for Non-governmental organizations	Not covered by IFRS	Not covered by IFRS
EAS 16	Segment Reporting	IAS 14 / IFRS 8	IAS 14 / IFRS 8
EAS 17	Public-Private Partnership (PPP) projects	Not covered by IFRS	Not covered by IFRS

Source: EASB, updated by the authors on 1 June 2007

In these cases the reason for the difference is quite clear and one can agree that the difference does not affect financial reports materially.

However, a more profound analysis shows that there are also areas of substantial differences that are not commented by EASB. These include different classification of sales – leaseback transactions what allows including gains on available-for-sale financial instruments in income statement, or allowing to use

equity method accounting for subsidiaries in non-consolidated financial statements. The reasons for these differences are not commented by EASB.

It is possible to find more differences when examining the effect of translation. Differences easier to explain are related to the terms of reduced or widened meaning. An example for that could be disclosure of taxes. IAS 12 income tax discusses only income taxes which are based on taxable profits of the entity or withholding taxes which are payable by subsidiary or associate on distributions to the reporting entity. EAS 2, presentation of financial statements includes all tax-like expenses (including social security payments, personal income tax withholding etc.). Differences appear where the current tax liability in the balance sheet is compared to the tax expense in income statements – often there is no tax expense at all, but there is material tax liability.

Truncation of texts and squeezing several IFRS-s into one EAS definitely makes understanding of the standards easier for practitioners, but shortening is also a cause of material differences. Examples of the differences are situations that are likely to occur and where EASB recommends, but does not require, to use the corresponding IAS. These are hedge accounting, employee benefits, disclosure of disposal groups and discontinued operations separately from other assets and liabilities. When there is no requirement to use IFRS in cases where the situation is out of scope of EAS, each preparer of financial statements can use its own approach.

Table 2-1. Main differences between the EAS and IFRS

EAS	EAS differences from IFRS	IFRS differences from EAS	Potential effect
EAS 0 and 1 Framework for the Preparation and Presentation of Financial Statements	Introduces general principle of “economic unit”.	More detailed requirements for disclosure.	None
EAS2 Presentation of Financial Statements	Pre-determined list of balance sheet and income statement line items. Operating profit disclosure mandatory.	Operating profit disclosure voluntary. More flexible for choosing income statement lines where expenses are recorded if there is an option to choose.	Because operating profit is not defined in either EAS or IFRS, there is a number of potential differences.

Table 2-2. Main differences between the EAS and IFRS

EAS 3 Financial Instruments	EAS 3 omits hedge accounting. No requirement to account certain financial instruments through equity, although it is acceptable to do so.	IAS 39 has extensive implementation guidance. Change in value of available-for-sale instruments must be credited directly to equity.	Depending on the circumstances, classification of financial instruments can be different. Changes in value of available-for-sale instruments are disclosed differently, which affects directly net profit for the period.
EAS4 Inventories	None	None	None
EAS 5 Property, plant, equipment (PPE) and Intangible assets	Requirement to determine lowest value for an item to be accounted for as an item of PPE. Revaluation of PPE was allowed only until the end of 2005. No requirement to disclose separately discontinuing operations and assets held for sale.	Only useful lifetime (more than one period) is basis for classification. Revaluation as an alternative accounting method allowed.	None Value of PPE in the balance sheet and shareholders' equity can be substantially different. Disclosure differences.
EAS 6 Investment properties	Positive variance between fair value of investment property and its cost on initial recognition is credited directly to retained earnings. No need to disclose fair value of the investment property when cost method is used.	Positive variance credited to revaluation reserve. Fair value of investment property must be disclosed in notes.	Retained earnings can be distributed to shareholders and therefore unrestricted equity in the EAS financial statements is larger. Financial statements may omit important information.

Table 2-3. Main differences between the EAS and IFRS

EAS7 Agriculture	None	None	None
EAS 8 Provisions, Contingent Liabilities and Contingent Assets	No guidance on accounting for employee benefits. No guidance for accounting for deferred income tax.	Separate standards for accounting for employee benefits and deferred income tax.	Differences are not likely, because there are very rare cases of post-employment benefits granted by the companies and deferred taxes.
EAS 9 Leases	Sale-leaseback transactions are accounted for as loans received on the asset as collateral.	Gain on sale-leaseback transactions may be amortised to income during the period of leaseback.	Income of the period may differ substantially.
EAS10 Revenue	None	None	None
EAS11 Business Combinations, Consolidated Financial Statements and Accounting for Investments in Subsidiaries	EAS includes business combinations under common control in scope of the standard. Exemptions from consolidation requirement based on legal requirements. Equity method accounting allowed for subsidiaries in case of exemptions in separate financial statements.	Business combinations under common control are excluded from the scope of the standard. Exemptions based on shareholders' agreement. Cost or fair value allowed for accounting for subsidiaries in separate financial statements.	In case of business combination between entities under common control the financial statements may be totally different. Difference in exemption rules may cause different understanding. Equity method accounting for subsidiaries may be confusing to users of the financial statements from abroad.

Table 2-4. Main differences between the EAS and IFRS

EAS12 Accounting for Government Grants and Disclosure for Government Assistance	None	None	None
EAS 13 Closing Balance Sheet		IFRS does not have standard for closing balance sheet.	
EAS 14 Accounting for NGO-s		IFRS does not have standard for NGO.	
EAS 16 Segment Reporting	None	None	None
EAS 17 Public-Private Partnership (PPP) projects		IFRS does not have standard for accounting for PPP projects.	

Source: author. Prepared using the following sets of standards: Estonian Accounting Law. http://www.legaltexts.ee; Raamatupidamise Toimkonna Juhendite nr. 0-12 kinnitamine. Riigi Teataja 2003;International Financial Reporting Standards (IFRSs ™) 2005, International Accounting Standards Board, 2005.

6. Conclusions

Harmonisation of accounting is used by most of the authors in literature as comparability of financial statements. Estonia has started harmonisation of its accounting standards with IFRS rather early and can be considered to be experienced in that process. Although accounting legislation emphasises that Estonian GAAP has to be based on IFRS, it does not require it to be harmonised with it. Analysis provided in the current article demonstrates that there are substantial differences between Estonian GAAP and IFRS and therefore the harmonisation of accounting on the level of accounting standards has not been achieved until now. The differences can be split into groups on the basis of the cause: differences due to the decision of EASB to select a different accounting method compared to IFRS; differences due to omissions of some IFRS standards from EAS; and differences due to translation of the standards. Based on the limited analysis provided in this article it is possible to conclude that the differences caused by the selection of one certain accounting method from

multiple choices and differences caused by omissions are the main sources of differences and incompatibility between EAS and IFRS compliant financial statements.

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