HARMONIZATION OF ESTONIAN ACCOUNTING SYSTEM WITH THE EUROPEAN FRAMEWORK

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1. Introduction

In July 2002 the European Commission has decided to oblige all EU companies listed on a regulated market, to prepare their consolidated accounts in accordance with International Financial Reporting Standards (IFRS, previously IAS). This requirement will enter into effect, at the latest, from 2005 onwards and represents a preliminary peak in the internationalization process of financial accounting in Europe. These perspectives require the analysis of the conformance of Estonian accounting regulation with the requirements of future European accounting framework.

The present paper examines the development of Estonian financial accounting system in association with business environment improvements. The paper makes a certain contribution to the existing accounting literature concentrating on transition countries. It has to be admitted that the number of studies focusing on developments in accounting system in the transition countries is fairly limited. Thus, at a more general level, our findings may shed light on the development of financial accounting in other developing societies presently undergoing rapid changes. Although we will examine the process of development and the position of financial accounting in Estonia, there are many features and contingencies that have influenced this area in other transition economies in a similar way.

The paper is organized as follows. The next section is a brief overview of accounting harmonization issue in Europe. The third section will present our findings on the development of financial accounting through three different stages of development: introductory stage, system building stage and system improving stage.

2. Accounting harmonization efforts in the European Union

The initial steps on the way towards the harmonization of accounting systems across Europe were gained through EU accounting directives, e.g. the Fourth Directive, signed in 1978, and the Seventh Directive, signed in 1983, which the Member States were obliged to implement into national law. These directives provided a base level for harmonization, as regarded reporting requirements for limited liability companies. But the issue of harmonizing accounting across the Member States was highly political task at this time (Haller, 2002, p. 156). Influenced by the national accounting traditions of particular states, the options of Directives have been carried out in different ways throughout Europe, which finally was the reason for not achieving the proposed and intended degree of comparability and equivalence of financial statements across Europe (*ibid*., p. 157).

Despite the differences in the implementation of the Accounting Directives into national laws, the impact of these directives was enormous, since it led to an obligatory codification of accounting rules with an identical scope through all national legislation. Particularly with reference to formal (formats of balance sheet and profit and loss account) and disclosure aspects national accounting systems have become similar in the EU, due to the directives (Thorell and Whittington, 1994, p. 219). The second set of regulations, International Accounting Standards, was not in the forefront of European accounting harmonization in the 1970s and 1980s. Principal Administrator and Head of Accounting at the EC Commission, Karel Van Hulle, argued that the particularities of the Member States of the EC are not sufficiently reflected in international accounting standards. This was the main reason why these standards are hardly applied at all by companies in the Community (Van Hulle, 1992, p. 169). Since 1996 the International Accounting Standards Committee (IASC) has undertaken a gradual and in-depth process of revision and development of the standards. In 1995, the IASC reached an agreement with the International Organization of Securities Commissions (IOSCO) that envisaged that since 1998 IOSCO would recommend to its members (the major stock exchange regulatory authorities throughout the world) that accounts drawn up in accordance with IAS should be accepted for foreign listings. Proceeding from these circumstances, in November of 1995, the European Commission announced an important change in its policy on accounting harmonization, in its communication "Accounting harmonization: a new strategy vis-à-vis international harmonization" (European Commission, 1995). The European Commission oriented the conformity of the EU directives with the IAS, to permit the use of the IAS and, at the same time, to ensure the continued respect of Accounting Directives. As outcomes of this policy were the European Commission's Communication on future of financial reporting in Europe in June, 2000 (Commission of the European Communities, 2000) and the decision arranged in June 2002, mentioned above.

Owing to the collapse of centrally planned economies in the late 1980s and early 1990s the situation in business administration in Eastern and Central European countries changed dramatically. The transformation process from a centrally planned to a market economy required extensive changes to be made in the organisation of accountancy and accordingly in the education and training process of qualified accounting specialists everywhere in the Central and Eastern European post-socialist countries (Bailey *et al.*, 1995; Garrod, McLeay, 1996; Krzywda, Schroeder, 1998).

Breaking free from the accounting regime of the era of central planning brought about the spread of accounting disharmony among the former socialist countries (Bailey, 1995, p. 611). The majority of Eastern and Central European countries, including Estonia, based their systems of laws on Codified Roman Law principles. Therefore, one of the first priorities was to set up an accounting regulation system based on laws of accounting. The movements in enforcements of new accounting legislation in different Eastern and Central European countries are listed in Table 1.

Table 1

Accounting regulations in Eastern and Central European countries

Country	Enforcement year	Accounting regulation
Poland	1991 1995	Decree of Minister of Finance Accounting Law
Czech Republic	1992	Law on Accounting
Estonia	1991 1995	Estonian Regulation on Accounting Accounting Law
Latvia	1993 1993	Law on Accounting Law on Financial Statements
Lithuania	1993	Law on the Principles of Accounting
Hungary	1992	Law on Accounting
Romania	1992	Law on Accounting
Russia	1996	Law on Accounting
Slovenia	1989 1991 1993 1993	Law on Accountancy in Yugoslavia Independence of Slovenia Companies Act (accounting particularities) Slovenian Accounting Standards
Yugoslavia	1989 1991	Law on Accountancy Accounting Standards

The accounting regulations enforced by transition countries during 1991–1996 contributed their integration into the international accounting environment. Therefore, among the other improvements made in accounting during the transition period, the first priority was given to financial accounting. This approach was justified, as it was first and foremost necessary to guarantee that the companies of the country would be able to prepare their financial statements in compliance with national accounting regulations and the generally accepted accounting principles. The idea that the companies should carefully observe the stipulations of accounting regulations was adamantly supported by the "big six" auditing companies[1] operating in Estonia.

However, in the first few years following the introduction of national laws on accounting some disharmony between the legal requirements and the actual accounting practice occurred, as many accountants with their Soviet-era background failed to grasp the intrinsically different nature of financial accounting in the conditions of market economy.

[1] KPMG, Arthur Andersen, Coopers & Lybrand, Price Waterhouse, Ernst & Young, Deloitte & Touche.

3. Integration of Estonian financial accounting system into the international framework

First stage – introductory stage (1990-1994)

The first step towards the formation of market economy accounting environment in Estonia was made by passing the Estonian Regulation on Accounting in 1990. As pointed out by Bailey (Bailey *et al*., 1995, p. 688), this event marked the beginning of the spread of accounting disharmony within the territories comprising the USSR. The introduction of subjective elements (depreciation rates, inventory valuation methods, assets valuation methods, etc. decided by companies) into the accounting practice, formation of a particular accounting policy, change from cash-basis accounting to accrual-basis accounting, introduction of some (unfortunately, not all, but proceeding from the particular circumstances, this was also intelligible) underlying accounting principles – the realisation principles, the matching principle, the historical cost principle served as an extremely radical change in the accounting framework of Estonia. Paradoxically, in some sense, as pointed out by Bailey (1995), that Estonian Regulation on Accounting, adopted prior to the recovery of independence in 1991, was more considered measure and wider in scope than the legislation introduced subsequently in Latvia and Lithuania.

Because of local lack of accounting sophistication there was some inability to distinguish between the suitable and unsuitable aspects of accounting procedures and practices transferred. Therefore, foreign advice appeared to be of great support in designing local accounting legislations. For example, three of the seven members of the Estonian Accounting Board during the period of preparation of the new Estonian Accounting Law (EAL) in 1993-1994 had international working experience.

The first step towards the formation of auditing environment in Estonia was made by the Estonian Regulation on Auditing in 1990 (the Estonian Law on Auditing (Authorized Public Accountants Act) was enforced in 1999). During the following years, 1992-1995, all the “big six” auditing companies started to operate in Estonia. In 1994 the first set of auditing guidelines was enacted in Estonia. These steps made an essential contribution to and helped create a favorable environment for the preparation and enforcement of the EAL.

However, it is evident, that both accounting as a whole and financial as well as management accounting in Estonia and the other transition economies underwent evolutionary changes in the first half of the 1990s. The main problem was following: how to build a forward-looking and flexible accounting regulation system, which would enable to overtake and to integrate into the European accounting framework. The traditional (see table 1) system basing on the accounting law would be too inflexible to reflect the rapid changes in transition circumstances. Although Van Hulle expressed an idea, that the use of the law as a means of standard setting can also be an interesting mechanism against too frequent (and sometimes unnecessary) changes (Van Hulle, 1993, p. 390). But this was not the case for transition countries, because of missing stable and effective accounting regulation system.

Second stage – system building stage (1995-2002)

Among the main impacts on the increasing demand of investors on comparability of financial information, Haller pointed out a steady increase in foreign direct investments (FDI) and the globalization of capital markets (Haller, 2002). These tendencies had their impact also for transition countries. In the second half of the 1990s, the development of the business environment in the Estonia was affected by the following events:

- conceptual changes and improvements in the regulatory context;
- ownership changes (the most intensive period of privatisation was 1993-1995);
- increasing FDI inflow;
- development of the capital market (the stock exchanges opened in Vilnius (Lithuania) in 1994, in Riga (Latvia) in 1995 and in Tallinn (Estonia) in 1996);
- recession on the Eastern markets (the Asian crises in 1997, the Russian crisis in 1998).

In the competition for FDIs Estonia has been rather efficient and has succeeded in attracting a significant amount of FDIs. Among the Eastern and Central European countries Estonia ranks third after Hungary and Czech republic by FDI inflow per capita in 1992-1999 (Foreign Direct Investments in the Estonian Economy, 2001, p. 4-5).

In the main, these systematic factors, increased competition and raised production quality standards required adoption of a more sophisticated and market-sensitive external (financial accounting) as well as internal management accounting systems.

In this circumstances, more substantial and complex step of the accounting reform in Estonia was related to the Estonian Accounting Law (EAL), which was enacted in 1994 and came into effect on January 1, 1995.

Chapter 1 of the EAL specified the objective of the EAL, which is to create the legal bases and establish general requirements for organizing accounting and reporting in the Republic of Estonia based on internationally accepted accounting principles. In paragraph 3 of the EAL internationally accepted accounting and reporting principles are defined as the accounting directives of the European Community and the principles, standards and recommendations developed and approved by IASC (*Hea raamatupidamistava,* 2000).

Although the EAL is in conformance with the EU 4th Company Directive and International Accounting Standards (IAS), as it was mentioned above, Estonian

International Accounting Standards Committee (IASC) orientation was not considered either wise or feasible in 1994 (Ilisson, 1999, p. 41). In November 1995 the Government of Estonia submitted an official application to join the European Union (Social-economic policy of EU, 1999, p.38). As the Government of Estonia had expressed Estonia's desire to enter the European Union, Estonian Accounting Board merged the requirements of the European directives with IASC's conceptual framework and treatments by carefully choosing the alternatives in the directives that result in convergence. Having monitored the directives vis-à-vis international accounting harmonization issue, it is interesting to note that Estonian strategy is now deemed both feasible and wise (Ilisson, 1999, p. 41).

Since 1995 the accounting framework and procedures in Estonian companies and institutions are legally regulated by the following items:

- Estonian Accounting Law (EAL);
- Accounting standards issued by the Estonian Accounting Standards Board;

Consequently, the Estonian financial accounting system constitutes as Estonian Accounting Law as well Estonian Accounting Standards, issued and improved by Estonian Accounting Standard Board. In some sense, this concept is a unique compilation of Anglo-American approach and Continental (European) approach. In Anglo-American framework accounting regulation is set up through professional standards. International Accounting Standards, and also national accounting standards as Statements of Financial Accounting Standards (SFAC-s) in United States (the SFAC-s are the major component of US GAAP) and Statements of Standard Accounting Practice (SSAP) in United Kingdom, are representing this approach. European accounting regulation is set up through national laws. EU accounting directives serve as set of initial requirements for these laws. In Estonian accounting regulation the Accounting Law is representing European approach and Estonian Accounting Standards Anglo-American approach. Such compilation has a number of advantages in the first period of accounting regulation creation (transition period) and enables the flexible manner of the transition process. Author's analysis of the accounting regulations in the Eastern and Central European countries revealed that, besides Estonia, only Slovenia has introduced the mentioned double set accounting regulation. In the second half of the 1990s this approach was implemented in several market economy countries – in Germany (Ebbers, 2001), in Norway (Norsk RegenskapsStiftelse), in Sweden (Swedish Accounting Standards Boards).

From 1995 till 2000 the Estonian Accounting Standard Board issued 16 accounting standards (EAS) to improve particular aspects of accounting in Estonia. This set includes standards concerning accounting aspects of the Conceptual Framework of Generally Accepted Accounting Principles; Revenue Recognition under the Revenue Principle; Liquidation and Termination Balance Sheet Preparation; Business Combinations; Balance Sheet Accounts; Income Statement Accounts; Equity Method; Leases; Consolidated Accounts of Credit Institutions; Government Grants;

Interim Report Preparation; Earnings Per Share; Segment Reporting; Long-term Construction Contracts; Consolidated Accounts.

To conclude this stage of the development of Estonian accounting system we compare the alignment of Estonian accounting rules with IAS. In 2000, by initiative of PricewaterhouseCoopers there has been carried out a survey of national accounting rules in 53 countries to investigate their alignment with IAS (GAAP 2000, 2000). The survey revealed that there were 17 items in Estonian accounting regulation, which can differ from that required by IAS. For example, in some other countries the number of corresponding items were following: Czech Republic – 31; Hungary – 37; Poland – 36; Russian Federation – 43; Finland – 32; France – 31; Germany – 35; Sweden – 18; UK – 16; USA – 20. This can comment (although there can be some speculative aspects) the flexibility manner of the Estonian accounting system.

Comparing the specifications of the issues handled in the Estonian accounting regulatory acts (EAL, EAS) and in the International Accounting Standards, it is evident that in the IAS the issues are discussed in greater detail. However, the regulatory accounting acts used in Estonia are in line with the International Accounting Standards and the requirements of the new European accounting harmonization policy.

Third stage – system improving stage (since 2003)

The third step of the accounting reform in Estonia was arranged through the new version of (EAL), which was enacted in November 2002, and a new set of Estonian Accounting Standards. Both of them came into effect on January 1, 2003.

The main characteristics of the new EAL and EAS are following:
- clear orientation to the IFRS;
- chapter 17 of the EAL specifies that the accounting methods and presentation of the information (financial statements) have to base on one of the following accounting principles:
    - Estonian Generally Accepted Accounting Principles,
    - International Financial Reporting Standards;
- Estonian Accounting Standards have to base on IFRS;
- Broadening scope: the EAL and EAS will be implemented for governmental institutions.

The principal aspects of the content and terms of issues of the new set of Estonian Accounting Standards, used since 2003 in Estonian accounting practice, and their relation to the International Accounting Standards are specified correspondingly in Table 2.

Table 2

Estonian Accounting Standards relation to the IAS

Number	Estonian Accounting Standard	Relation to the IAS
EAS 1	Framework for the Preparation and Presentation of Financial Statements	Relation to the IAS
EAS 2	Presentation of Financial Statements	IAS 1, 7
EAS 3	Financial Instruments	IAS 39
EAS 4	Inventories	IAS 2
EAS 5	Property, plant, equipment and Intangible assets	IAS 16, 38, 36, 23
EAS 6	Investment properties	IAS 40
EAS 7	Agriculture (draft)	IAS 41
EAS 8	Provisions, Contingent Liabilities and Contingent Assets	IAS 37
EAS 9	Leases	IAS 17
EAS 10	Revenue	IAS 18, 11
EAS 11	Business Combinations, Consolidated Financial Statements and Accounting for Investments in Subsidiaries	IAS 22, 27, 28, 21
EAS 12	Accounting for Government Grants and Disclosure for Government Assistance	IAS 20, 41
EAS 16	Closing Balance Sheet	-
EAS 17	Interim Report	IAS 34
EAS 18	Segment Reporting	IAS 14
EAS 19	Earnings Per Share	IAS 33

Comparing the specifications of the issues, given in Estonian accounting regulatory acts (Estonian Accounting Law, Estonian Accounting Standards) and in IFRS, it is evident that the issues in IFRS are treated in more detail. Regarding the definitions, it can be conclude that substance over form is the best way to characterize definitions stated in IFRS. From other side, despite the fact, that the issues in EAL and EAS are treated in less detail, the regulatory accounting acts used in Estonia are in line with International Financial Reporting Standards. Therefore we can conclude that Estonian accounting regulation, including EAL and accounting standards, is in line with the requirement of new European accounting harmonization policy.

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Kokkuvõte

EESTI MAJANDUSARVESTUSE SÜSTEEMI HARMONISEERUMINE EUROOPA KESKKONNAGA

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Euroopa Komisjon võttis 2000. aasta suvel vastu avalduse, mille kohaselt tuleks hiljemalt 2005. aastast muuta Rahvusvaheliste Raamatupidamisstandardite (IAS) järgi koostatud aruandlus kohustuslikuks kõikidele Euroopa Liidu börsidel noteeritud firmadele ja lubada IAS-ist lähtuvat aruandlust kõigile ülejäänud ettevõtetele. Samas säilitatakse Euroopa Liidu 4. ja 7. direktiivi primaarsus IAS suhtes.

Eesti majandusarvestuse süsteem põhineb Eesti raamatupidamise seadusel ja Raamatupidamise Toimkonna poolt välja antud juhenditel (standarditel). Selline kahel arvestust reguleerival kogumil põhinev süsteem muudab arvestuse arengu protsessi paindlikuks ja võimaldab paremini reageerida arvestussüsteemi muudatustele rahvusvahelisel tasandil. Vastavalt PricewaterhouseCoopers'i poolt 2000. aastal teostatud uuringule on Eesti tänases arvestussüsteemis oluliselt vähem ebakõlasid IASiga võrrelduna näiteks Ungari, Poola, Saksamaa Liitvabariigi, Soome jmt. riikide arvestussüsteemidega. Artiklis vaadeldakse Eesti majandusarvestuse süsteemi arengut läbi kolme etapi: sissejuhatava, süsteemi loomise ja süsteemi arenduse etapi.