

## INTERNATIONAL ACCOUNTING STANDARDIZATION AND ECONOMICS PRACTICE

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### **ABSTRACT**

*This paper traces the benefits of international accounting standards and their contribution to harmonization in business practice. The author measured and valued the effects of international standards on the business economic environments. There was shown that uniform management accounting standards will increase market liquidity and division of labour, decrease transaction costs for investors, lower cost of capital, and facilitate international capital formation and flow. Reduced costs will also result in more cross-listings and cross-border investments. This survey contains information on how local, national accounting rules differ from International Financial Reporting Standards (IFRS) on incorporating recognition, measurement, and disclosure rules. To analyze business adoption decision my sample consists of Budapest Exchange Trade (BET) companies who compulsory adopted international financial reporting standards in Hungary, from 2007. In this research the pre-adoption examination period is in year of 2006 and the post-adoption is in year of 2007. In the scientific research methodology the author assigned that the Balance Sheet indexes deteriorated especially regarding solvency and prosperity after adaptation of IFRS. Earnings management reduced after the post-adoption period. Business management has more value relevance in the IFRS adopted enterprises.*

**Keywords:** *management information system, international accounting standards, economics of standards, management performance effects, value-based management.*

### **1. INTRODUCTION**

The goal of business management is to provide a set of tools that can be used to meet the requirements of each application. Since accounting applications do not have uniform security and reliability requirements, it is not possible to devise a single accounting protocol and set of security services that will meet all needs. Business management requires that resource consumption be measured, rated, assigned, and communicated between appropriate parties.

Managers of businesses use accounting information to set goals for their organizations, to evaluate their progress toward those goals, and to take corrective action if necessary. International accounting information system renders its services to a wide variety of users: investors, government agencies, the public, and management of enterprises, to mention but a few. Many accountants work in business firms as managerial accountants, internal auditors, income tax specialists, systems experts, controllers, management consultants, financial vice presidents, and chief executives. Accounting is, therefore, a service to management, a special-purpose tool which must be used but not misused. Like any special-purpose tool, if it is neglected or not used it will surely go rusty and fail to provide the good service for which it was designed. However, all tools have their limitations and it is well to point out at this early stage some fundamental limitations inherent in any system of accounting.

Accounting is different from other business functions in that it is not only a function but also an industry. The accounting industry sells accounting and other advisory services to other businesses and is itself a major employer of graduate labour. Accounting can be and is used within business to evaluate and shape alternative strategies such as making a component of buying it in from a supplier, thus shaping business plans and

activities. At the same time it is itself a function of the type of activity that a business engages in and of the strategies a business adopts.

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

According to the business practice it is obvious that the usage of harmonized international accounting system leads to a reduction of the information asymmetry between the owners and the managers. By this information asymmetry are growing the costs of equities and are less accurate the economical and financial forecasts. This requires the development and review of the national accounting rules, the separate validation of the tax and accounting regulation, the repeal of the subordinate role of accounting, issuing international standards with the help of practical and theoretical accounting experts.

Since in case such multinational companies like Daimler Chrysler owning more than 900 subsidiaries, operating in 5 continents in more than 60 countries, the published financial results according to international accounting system is 1.5 times of the one according to German accounting rules. If earning after taxation (EAT) – deducted actual tax burdens - according to US GAAP (Generally Accepted Accounting Principles) is taken as 100 percent, due to differences between national accounting rules, EAT would be 25% more in UK, 3% less in France, 23% fewer in Germany and 34% less in Japan (Barth et al., 2007).

An analysis (Ormrod & Taylor, 2006) of non-economic entities among the 100 largest companies listed on London stock market was performed and published by the University of Liverpool, UK. This research created according to international accounting gave unique opportunities to retrieve comparable data. Financial performance of given period was examined and introduced according to international as well as British accounting standards indicating that in case of 50 out of 100 economic entities, conversion into IFRS would increase EAT by 39%. Analysis was performed to find out which standards are reliable for that and turned out that only several of them caused the differences. In most of examined standards, results differed in a small proportion. Results were weighted on the bases of economic entities' size. Significant difference (24%) was indicated by the review of goodwill. Financial investments accounted for the second important factor, resulting 13% changing. Applying to international accounting standards could decrease shareholders fund by 23%. Converting to IFRS would indicate the most significant decrease in allowances (including pension), namely 26%. Surprisingly most of the standards had minor deviations were indicated by dividend (3%) and finite tax change (1%). Allowances – especially pension – was expected to have significant effects, but it rather reflected the changes of British regulations instead of IFRS. Deviations of financial statement derived from different accounting system could hardly measure in case of such large companies like British Petrol.

In countries whose culture is characterized as small power distance and weak uncertainty avoidance, one would expect a greater tendency to use accounting measures as an indicator of the results of the manager's decisions. Thus, the profit of a profit centre is more likely to be used as a measure of manager performance than to indicate the effectiveness of policies and procedures prescribed for the manager. Likewise, cost is more likely to serve as an indicator for the results of decisions made by a cost centre manager. For example, in the US and Taiwan found that managers in many Taiwanese firms did not have the full range of general management skills because the boss virtually all of the decisions. Taiwan's strong uncertainty-avoidance and long-term orientation are consistent with this tendency toward centralization. Germany's strong uncertainty-avoidance culture also suggests a tendency toward centralization. Evidence of such a tendency is provided by an automobile industry expert. „Of the top 100 managers - at Volkswagen -, 50 are not used to making their own decisions or thinking on their own.” (Lere, 2009: 5).

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

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

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

The transition to IFRS presents firms with difficulties including technical differences, the cost of change and adjustment, the time factor, and the insufficient experience and knowledge. In addition the fair value orientation of IFRS is likely to introduce volatility in book values and reported earnings, and consequently, distort the financial profile of adopting firms. These considerations may influence the financial behaviours of businesses and may motivate them to redefine their strategies and decision-making processes in order to mitigate the adverse impact of adoption on their accounting numbers.

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

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

The first argument for the harmonization of accounting information systems is the existence of the multinational companies, who invest enormous efforts into the preparation of their financial reports in order to comply with the national standards. For these companies life would be much easier if the same rules would be applied to their subsidiaries all around the world. On the other hand this would be profitable for the investors as well, as they could compare the enterprises' results without difficulties, which would spare both money and other resources for them. This would also lead to the reduction of the information diversity between managers and investors. The information diversity is a costly and can be blamed for the decrease of the managers' bonus, the increase of the equity's cost and the inaccuracy of the economical and the financial forecasts.

## 2. PREVIOUS RELATED LITERATURE REVIEW

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

Prior researches (e.g. Meeks and Meeks, 2002) have raised substantial doubt regarding whether a global accounting standard would result in comparable accounting around the world. But differences in accounting practices across countries can result in similar economic transactions being recorded differently. This lack of comparability complicates cross-border financial analysis and investment.

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

Chatterjee (2006) assigned that first time mandatory adopters experience statistically significant increases in market liquidity and value after IFRS reporting becomes mandatory. The effects were found to range in magnitude from 3 % to 6 % for market liquidity and from 2 % to 4 % for company by market capitalization to the value of its assets by their replacement value.

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

The increased transparency promised by IFRS also could cause a similar increase in the efficiency of contracting between firms and lenders. In particular, timelier loss recognition in the financial statements triggers debt covenants violations more quickly after firms experience economic losses that decrease the value of outstanding debt (Ball and Lakshman, 2006, Ball and Shivakumar, 2007).

Accounting theory argues that financial reporting reduces information asymmetry by disclosing relevant and timely information (e.g. Frankel and Li, 2004). Because there is considerable variation in accounting quality and economic efficiency across countries, international accounting systems provide an interesting setting to examine the economic consequences of financial reporting. The EU's movement to IFRS may provide new insights as firms from different legal and accounting systems adopt a single accounting standard at the same time. Improvement in the information environment following change to IFRS is contingent on at least two factors. First, improvement is based upon the premise that change to IFRS constitutes change to a General Accepted Accounting Principles (GAAP) that induces higher quality financial reporting. Second, the accounting standards are a complementary component of the country's overall institutional system and they are also determined by businesses' incentives for financial reporting (Ball et al., 2006).

La Porta (1998) provided the first investigation of the legal system's effect on a country's financial system. He found that common law countries have better accounting systems and better protection of investors than code law countries. Other factors associated with financial reporting quality include the tax system (Daske and Gebhardt, 2006), ownership structure (Burgstahler et al., 2006, Jermakovicz et al., 2007), the political system (Gwilliam et al., 2005), capital's structure and capital market development (Ali et al., 2000). Therefore, controlling for these institutional and firm-level factors becomes an important task in the empirical research design. As a result of the interdependence between accounting standards and the country's institutional setting and firms' incentives, the economic consequences of changing accounting systems may vary across countries. Few papers have examined how these factors affect the economic consequences of changing accounting standards. For example, Pincus et al. (2007) measured that accrual anomaly is more prevalent in common law countries. Maskus et al. (2005) explored that accounting quality is associated with tax reporting incentives. Exploration of the interaction between these factors and the accounting standards can provide insights into differences in the economic consequences of changing accounting principles across countries.

### **3. ECONOMICS OF ACCOUNTING STANDARDS**

#### ***3.1. Role of accounting standards in the division of labour***

Even the work of Adam Smith concerning division of work demonstrate the significant change that leads from economic entities managed by its owner through divided leadership from shareholder till hired management. Hired management of limited partnership may provide further options for maximize risk management and financing such projects that exceed those available for economic entities managed by its owner. In addition monitoring fund assessment and investment may be challenging without hired experts. Informational asymmetry

may occur concerning asset valuation namely external shareholders are usually less informed of financial investments than hired managers what also may cause motivational anxiety. As Adam Smith (1776) has written "Management of such partnerships rather handles shareholders' investments than its own thus the same caution could not be expected that lead to lavishing of funds..."

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

Concerning decisions on fund assessment and investments Smith (1996) gave the following examples for the misuse of accounting standards: The Coloroll share company operation in the UK, grew to 10 times of original company within 4 years thanks to acquisitions but kept low rate of (fictive) profit by using accounting tricks, "creating reorganizing reserves". Next year its capital has degraded and bankrupted. The Accounting Standard Board (ASB) has created and published unified principles and accounting methods to avoid such misunderstandings, differences and failures between economic entities participating in the division of labour. Their aim was to eliminate bankruptcy of such large company like the British Coloroll or the American WorldCom. The board consisting of accounting researchers, experts, auditors aimed to create such standards like restrains management from misinforming shareholders concerning the profit achieved by company or the amount of dividend. In addition Easley and Hara (2004) have created such accounting methods that restrain management from altering former performance, results. Similar case has been published recently in Hungary: the First Hungarian Natural Gas and Energy Trading and Service Provider Ltd tried to alternate its profit by self-revision to "achieve" loss. Camferman et al., (2006) - in their study - introduced methods that may prevent company management from misinforming shareholders by motivating them to apply accounting standards especially in the statements of their performance and funds.

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

On the basis of the standard reports the fiscal and the economic situation of the companies becomes more transparent and comparable among the different countries. The unified standards favour especially for the smaller investors' interest because it is the most difficult for them to examine and compare the data of the

statements of different countries. The cost of acquiring the information will be much lower. This transparency and comparability boosts the process of international division of labour at a standard world-market too. So it will be much easier for investors to place their investment to the joined countries, and they can harness the comparative advantages of the international division of labour.

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

### **3.2. Accounting standards and financial innovation**

Statement that standardization has a leading role in innovation is proven in numerous studies e.g. Temple (2005). According to data provided in above mentioned study, 50% of the interviewed person conceived that accounting standards promote innovation. The other 50% of them stated that standards restrain innovation. This involves that standards may promote or restrain innovation as well. This could question mark the role of standards in innovation. As mentioned above and argued by Smith, division of labour promote innovation. New markets could be achieved by using standards thus new markets entries and products may give a significant boost to innovation – as argued by Hesser et al. (2006).

Using widely accepted standards for innovative products could also result in better sales figures. Without these standards, low-quality products and remaining stocks could not be relocated, thus innovation would lose its economy-boosting effect. In addition new standards expand the scale of innovative products, market entries thus without new standards, innovative products could be hardly obtained. Loan contracts may also provide us with a perfect example for the role of standards in financial innovation. International accounting information has already took a significant part of such contract, but for now adapting these information for performance assessment become more and more complex. Fluctuation of interest rate is highly influenced by innovation (Radebaugh and Gray, 2007). This involves that higher risk advantage could be achieved through lower interest rate and the lack of negotiations before signing contracts. On the other hand lenders are compensated through exercising extra premium in the interest rate. With such a warranty, lower interest rate could be set, thus both lender and debtor could meet beneficial offer. Even so in some case – e.g. mentioned in their study of Meeks and Swann (2009) – terms indicated in the contract were defaulted due to false determination of profit, lowered loan risks “accounting tricks” or due to defaulted payment of instalment. Thus uniformed contract and standardized international accounting methods should be introduced.

In many countries the growth of the financial leasing proves that leasing is like a financial innovation that obtained a long-lasting position in the economic life. The success of leasing could be explained by the arising needs of financial capacity in the economy, and not with the temporary favourable environmental conditions. Alongside the clients in the frame of financial innovation there is an increasing demand for services and goods for handling wealth, and for that, to have a higher benefit in the case of unfavourable financial conditions. Nowadays, in many countries the accounting systems do not put the interests of the investors at the first place primarily, but the interests of the credit banks and tax aspects. The introduction of the IFRS helps countries to converge their accounting systems to the Anglo-Saxon model, where the report is made on the ground of the aspects of the investors. The standard system could help to spread the financial innovations in a wider environment, because the IFRS is similar to the Anglo-Saxon approach and it is the most efficient where there is a prosperous capital market. It would support the spread of the financial innovations worldwide and the unified attendance in the accounting systems.

### **3.3. The effects of accounting standards on the transaction costs**

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

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

Similar effects could be experienced in case of mergers and acquisitions in the USA (Doupnik and Perera, 2007). Since market participants were not touched by the fact, that increased profit was due to amortizing assets not performed before merge. Consequently standards should be used to eliminate manipulations, extra work caused by the alternations and unnecessary costs.

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

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

Zeff (2006) highlights the cost-saving effect of international accounting principles in connection with contracts since without their standards, lender would be forced into contracts that may push them toward bankruptcy.

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

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

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

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

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

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

### **3.4. Accounting standards decrease costs of capital**

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

About 1000 foreign companies registered at SEC, converted their accounting reports from their national accounting rules according to US GAAP and are listed and traded on the stock market of USA. But only some of them have such investment instruments (instrument of governance, ability to classify and account activities, ability to initiate claims) that are common used in the US, exposing their voluntarily to risk of being sued on the basis of insufficient investment-protection. Thus risk of exchanging stock may also increase the cost of capital since it is connected to the risk level of investment (decreasing risk factors results in the decrease of transaction cost emerging during investment). Risk may include the reliability of the accounting statements of business' financial position its performance. The cost-saving effects (through decreasing risk level of assets) of reliable and true financial statement is proven by numerous studies (including Butter et al., 2007, and Bradshaw et al., 2008 researches) since reliability of accounting data effect on the prices of assets. The above mentioned studies have pointed out, that only that management could take effect on the cost of capital which has provided exact and reliable information to shareholders. Accordingly international accounting standards and unified methods could assist shareholders since unreliable reports could mean a possible risk-factor. This accounting model based on the principles of historical costs for invested vehicles distort it's the real value if late is defined as realizable income from cash flow applying financial resources. The invested vehicles receive criticism nowadays that may lead to the review of financial resources' evaluation. Necessity for re-evaluating applied international standards of the financial instruments was suggested by expert due to present sub-primed mortgage and economic crisis.

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

There is also risk based not on the underlying financial reporting principles, but on the confidence that the reporting entity has faithfully applied them. This depends on the investors' belief in the regulatory regime overseeing financial reporting (e.g. Security Exchange Commission – SEC – enforcement), and on the auditors' capabilities and willingness to enforce GAAP or IFRS rules. While auditors' honesty is challenged (such as Parmalat case had happened in Italy), the reluctance to confront clients opting for aggressive interpretations of accounting standards is more widely acknowledged. It is finding out, that the reducing accounting risk should have salutary effects on the cost of capital. A number of academic studies have investigated this premise, with overall positive, although there is not unanimous support for this proposition. Investor confidence in a given entity's financial reporting depends on more than the financial reporting standards it claims to subscribe to. For examining accounting standards from a different point of view confirmed the fact, that unreliable information used in reports may further increase cost of capital. The complexity and misconception of financial statements may cause higher risk factors resulting in longer rate of return and higher costs of capital. Without doubt it may be concluded that accounting risk could be lowered with the use of reliable and true international accounting standards.

In an increasingly global international environment a better developed international financial reporting system is becoming more important by the day. The advantages of more standardized national accounting rules and more



comparable financial report are manifold. One of these advantages is the decreasing cost of capital. Investors may accept lower returns (interest on debt, dividends, and capital appreciation on equity) if on the other hand they only have to take lower risks. This is true if the international standards are properly enforced by the regulatory regime.

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

#### 4. METHODOLOGY AND RESULTS

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

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

**H<sub>1</sub>:** The Management performance indexes deteriorated especially regarding solvency and prosperity after adaptation of IFRS in the examined companies' case.

**H<sub>2</sub>:** IFRS adoption reduced earnings management.

The purpose of this study was the measuring the differences between the national rules and the international methods, the valuing and analyzing their effects on the business decisions. This survey contains information on how local, national accounting rules differ from IFRS on incorporating recognition, measurement, and disclosure rules.

To analyze business adoption decision my sample consists of Budapest Exchange Trade (BET) companies who compulsory adopted international financial reporting standards in Hungary, from 2007. In this research the pre-adoption examination period is in year of 2006 and the post-adoption is in year of 2007. My final sample comprises 65 IFRS adopting and 260 local (Hungarian) accounting rules user firms. For the chosen of the national accounting rules user enterprises I introduced mathematic-statistic methods. An alternative approach it to create a matched sample of local rules businesses based on criteria such as year and industry. It is chosen to incorporate all local rules firms due to methodological concerns about the matched-pairs research design. Financial data are from published accounting statements in BET and Hungarian Business Information database. In my sample the businesses are classified into those following IFRS and those following national accounting rules.

##### 4.1 Accounting methods and management performance effects

This set of analyses measures how Hungarian enterprises have been affected on management performance by IFRS. The logistic regression models employed are as follows (1,2):

$$RR_{i,t} = a_0 + a_1 Size_{i,t} + a_2 Dividend_{i,t} + a_3 Growth_{i,t} + a_4 Profitability_{i,t} + a_5 Liquidity_{i,t} + a_6 Leverage_{i,t} + ei_{i,t} \quad (1)$$

$$PA_{i,t} = a_0 + a_1 Size_{i,t} + a_2 Dividend_{i,t} + a_3 Growth_{i,t} + a_4 Profitability_{i,t} + a_5 Liquidity_{i,t} + a_6 Leverage_{i,t} + ei_{i,t} \quad (2)$$

Where:

$RR_{i,t}$  = dummy variable, indicating the regulatory system,

$RR_{i,t} = 1$ , financial numbers are reported under IFRS,

$RR_{i,t} = 0$ , financial numbers are reported under National GAAP,

$PA_{i,t}$  = dummy variable, indicating the post-adoption effects.

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

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

Size: Natural logarithm of market capitalization:

- NAVSH: Net asset value per share

- *RESSFU*: Reserves to shareholders' funds
  - Dividend*:
  - *DIVCOV*: Dividend cover
  - *DIVSH*: Dividend per share
  - *DIVYI*: Dividend yield.
  - Growth*:
  - *MVBV*: Market value to book value
  - Profitability*:
  - *EPS*: Earnings per share
  - *NPM*: Net profit margin
  - *ROCE*: Return on capital employed
  - Liquidity*:
  - *CFM*: Cash flow margin
  - *CUR*: Current ratio
  - *OCF*: Operating cash flow scaled by total assets
  - *QUI*: Quick ratio
  - *WCR*: Working capital ratio
  - Leverage*:
  - *DEBTE*: Debt to equity
  - *DSFU*: Debt to shareholders' funds
  - *CGEAR*: Capital gearing
- $e_{i,t}$  = the error term

The results are reported in table 1.

**Management performance effects Table 1**

<i>Denomination</i>	<i>National GAAP employed enterprises</i>		<i>IFRS adopted enterprises</i>	
	<i>Mean</i>	<i>Std. deviation</i>	<i>Mean</i>	<i>Std. deviation</i>
<i>DIVSH</i>	0,0846	0,1986	0,1557	0,2106
<i>DIVYI</i>	17,5764	19,8721	22,8705	25,4457
<i>MVBV</i>	5,8152	7,8125	2,5478	8,1547
<i>NPM</i>	-0,2945	4,5412	-0,1031	7,4581
<i>EPS</i>	0,1987	1,0561	0,1897	1,5061
<i>ROCE</i>	0,2008	0,3051	-0,0081	0,6401
<i>OCF</i>	3,8812	15,4421	4,8512	16,8041
<i>CUR</i>	1,9911	6,9105	2,9814	3,1125
<i>CFM</i>	0,8029	2,3126	-0,0408	1,5974
<i>DEBTE</i>	1,9843	2,3566	2,3099	2,1577
<i>CGEAR</i>	0,3454	0,2325	0,8714	0,3115
<i>DSFU</i>	0,3258	0,1353	0,5469	0,8540

(Source: Author's own constructions)

It is provable by the table 1 that the average index of dividend, share (coming from earnings after tax) is more prosperous at companies which already adapted the international financial reporting standards (IFRS) than in case of others. However, the relative average value (DIVYI) contains a high deviation (the deviation value is almost 30 in case of companies operating with IFRS).

The companies applying the national accounting standards are gaining more than double (5,8152) in terms of growth, measured by market value of assets to historical value of assets, respect to other enterprises. In this sense the IFRS user companies' average index is much lower.

The monitored enterprises had a negative average net profit value (loss) in both group in the covered period. However the return on equity and the average return on capital employed give better results in case of national accounting standards users. The latter index showed a declining tendency (-0,0081) at companies which adapted the IFRS.

The examined national accounting standard user companies' average indexes, measuring solvency (OCF, CUR, CFM) and leverage were more prosperous than the other ones'. The Cash Flow, for instance, decreased (-0,0408) at IFRS user companies, though around the relative average value of Operating Cash Flow on assets the deviation is quite high (it is between 15 and 17). As the indebtedness of companies accounting according to national regulation was lower, the leverage indexes (DEBTE, CGEAR, DSFU) were better than the other companies which adapted IFRS.

To sum up, it can be stated that the management performance indexes deteriorated especially regarding solvency and prosperity after adaptation of IFRS in the examined companies' case.

#### 4.2 Accounting methods and earnings management

The first earnings management test measured the volatility of the change in net profit scaled by total assets,  $\Delta NP$ , and the volatility of the change in net profit to the change in operating cash flows,  $\Delta CF$  for the national GAAP employed and the IFRS adopted enterprises.

The second earnings management test examined the associations between accruals and cash flows. My scientific research evaluated the Pearson correlation between accruals and cash flows separately in the pre-official, official and post-official adoption periods. Then the author employed an Ordinary Least Square (OLS) regression, followed Iatridis,G. and Rouvolis,S. (2010) researches, to analyze the associations between accruals and cash flows, profitability, leverage and size. The regression model that is used is as follows (3):

$$ACCR_{i,t} = a_0 + a_1FRS_{i,t} + a_2FRSOFC_{i,t} + a_3FRSLNMV_{i,t} + a_4FRSOPM_{i,t} + a_5FRSTLSFU_{i,t} + e_{i,t} \quad (3)$$

Where:

$ACCR_{i,t}$  = Accruals scaled by total assets.

$FRS_{i,t}$  = Dummy variable indicating the financial reporting system in use.  
 $FRS_{i,t} = 1$  for firms reporting under IFRS in 2007,  
 $FRS_{i,t} = 0$  for firms reporting under the National GAAP in 2006.

$OCF$  = Multiplication of IFRS and operating cash flows.

$FRSOFC_{i,t}$  = Variable used to examine the impact of IFRS on the association between accruals and cash flows.

$LNMV$  = Multiplication of IFRS and the natural logarithm of market value.

$FRSLNMV_{i,t}$  = Variable used to examine the impact of IFRS on the association between accruals and size.

$OPM$  = Multiplication of IFRS and operating profits margin.

$FRSOPM_{i,t}$  = Variable used to examine the impact of IFRS on the association between accruals and profitability.

$TLSFU$  = Multiplication of IFRS and total liabilities to shareholders' funds.

$FRSTLSFU_{i,t}$  = Variable used to examine the impact of IFRS on the association between accruals and leverage.

The results of the previous regression model (3) the author summarized in table 2.

**Accounting methods and earnings management - Table 2**

<i>Denomination</i>	<i>National GAAP followed enterprises</i>	<i>IFRS adopted enterprises</i>
$\Delta$ NP volatility	4,1581	6,1021
$\Delta$ NP/ $\Delta$ CF volatility	11,4401	12,0120
FRSOCF	-1,21**	-0,7145**
FRSLNMV	-0,025**	-0,014*
FRSOPM	0,5541**	0,2145**
FRSTLSFU	-0,2574**	-0,1941**
R <sup>2</sup>	0,784	0,815

\*Statistical significance at 10% level (two-tailed),

\*\*Statistical significance at 1% level (two-tailed).

(Source: Author's own construction)

According to the results of the table it can be stated that the companies which adapted IFRS reached a higher volatility in Net Profit value change ( $\Delta$ NP) and in Net Profit value change/Operating Cash Flow value change ( $\Delta$ NP/ $\Delta$ CF). Being so, the volatility did not decline after the standard adaptation, contrary to the companies using national accounting standards.

The coefficient of correlation between deferred items, namely Accrued Charges and Cash Flow (FRSOCF) had a negative value in a significance level of 5 % in both group, even so, the leaders of the national accounting principle user companies gained higher income (-1,21).

The coefficient showing correlation between deferred items (accruals) and size of the company (FRSLNMV) was also negative: (-0,025) in a significance level of 10%, (-0,014) in a significance level of 5%; accordingly even the bigger companies using IAS/IFRS could not insert totally the principles of accounting accruals in their system yet.

Similarly, the companies which already adapted IFRS did not increase their Accrued Charges as a consequence of high indebtedness, which is showed by the coefficient of correlation between deferred items (accruals) and leverage (FRSTLSFU) being (-0,1941).

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

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

## 5. CONCLUSION

My study scrutinized the consequences of the IFRS adoption. The practical results showed an unpleasant picture regarding solvency and profitability at the examined companies.

My analyses have proven that the internal efficiency measured by accounting indicators of the concerned companies depended on their financial situation, their capitalization also after IFRS adaptation. As stated before, the IFRS adaptation had an influence on decreasing income of leaders/managers too.

According to the previously quoted studies and researches, the reported accounting results after IFRS adaptation are no more flexibly changeable and as a consequence of cost-benefit accounting, they are transparent too. Being so, the IFRS are becoming one of the most efficient tools for internal performance measurement and evaluation.

I have examined the practical realization of the assumptions supposed, through accounting data of national companies (in the sample) and I found that – except for some case – the results were in correlation with my previous statements.

As a consequence of the IFRS adaptation the policy and requirements became gradually more transparent and bright, so as became the application of the standards and the implementation process more user friendly. The author can advise for international management researchers to employ these methods and measure their effects on practical management functions.

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