THE INTERNATIONALIZATION OF THE ESTONIAN ACCOUNTING SYSTEM

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ABSTRACT: The purpose of the given article is to explore, describe, compare and sum up the process of internationalization of financial accounting in Estonia in the period of market economy. The research methods used comprised investigating specialist literature and valid international and local standard documents. The data received from a questionnaire about the influence of the latest amendments in acts on the administration of financial accounting in companies, were used. Specialists’ opinion and estimates were used in drawing conclusions. The transition from planned economy to market economy actually meant the creation of a new accounting system. At the same time the legal reform of accounting took place, which called for the preparation and enforcement of legal acts. The period under study (1918-2008) embodies respectively periods with little legislation, almost no legal requirements, enormous social changes and integration the Estonian accounting system into the international framework.

KEY WORDS: accounting legislation; internationalization; accounting problems

JEL CLASSIFICATION: M40

1. INTRODUCTION

The activity of accounting is long and rich in traditions, dating back to the era of several ancient civilizations (Babylon, Egypt, China, etc.) about 4,000 years ago. Much of what we know about culture, traditions and economy of the ancient nations comes from accounting records, found at archeological sites. The development of accounting to the modern level took place alongside several other factors, such as the development of calligraphy and mathematics, business administration, the emergence of private property, the development of trade.

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Similarly to other Central and Eastern European countries the history of accounting had not been extensively researched in Estonia until recent times, i.e. after the collapse of the socialist regime. The development of accounting in Estonia has to be viewed within the framework of historical changes and general cultural development of the country. The regained independence of the Republic of Estonia in 1991 brought along the transfer from the centrally planned economy to market economy, which led to radical changes in the economic system of the country. At the same time the legal reform of accounting took place, which called for the preparation and enforcement of legal acts. The period under study embodies respectively periods with little legislation, almost no legal requirements, enormous social changes and integration the Estonian accounting system into the international framework.

Within the last decade several Estonian researchers have investigated the history of financial accounting, its development and administration both globally and in Estonia as in a country of transition.

Kallas (2002) deals with the most important development stages of accounting from Luca Pacioli’s treatise “Summa de Arithmetica, Geometria, Proportioni et Proportionalita” to the present, emphasizing a remarkable acceleration in the development process of accounting in the 19th century and in the early 20th century, when the main forces of development were the industrial revolution, the rapid development of technology, the emergence of new forms of business (corporations) and an increase in the management of business activities by the state. The emergence of cost accounting in the 19th century can be considered as a result of the industrial revolution. In the 20th century financial accounting become closer to statistics. Economic mathematical models and calculation machinery came into extensive use.

Järve (2006) treats the historical development process of accounting as a series of rises and falls that can be characterized by three conceptual levels. At the first level, the accounting object was counted in a simple, direct and natural way and the results were fixed, i.e. accounting on primitive data carriers available. At the second level, accounting transactions were already documented. Thus, the accounting object was significantly changed - it was not objects in their natural form any more but information about them fixed in documents. The third conceptual level, which was defined only in the second half of the 19th century, is characterized by the emergence of several accounting theories, which made it possible to interpret accounting information and its indicators separately. This meant also that the essence of accounting could be expressed by relations between profit, cash and assets, i.e. by profit paradoxes.

The aim of financial accounting is to present and report information to internal and external interest groups, which can be used in making managerial, investing and financing decisions. The task is ‘evergreen’ and has not changed over years. Acquisitions, amalgamations, mergers and the internationalization of economic activities in general, especially since the beginning of the 20th century, have contributed to the spread of both accounting methodologies and procedures from one country to another. The formation of accounting policies presumes the establishment of specialist organizations in a country as well as at the global level. Thus, the state legislation on accounting was introduced and developed at the national level; at the global level international accounting standards were worked out and amended. Today,
acts regulating financial accounting in different countries are being harmonized with the international accounting standards. It is caused by an increasing economic and political interdependence of the member states of economic communities as well as autonomous countries, and by an interest in generating and presenting comparable economic information. Several leading industrial states (e.g. Australia, Canada, Russia, the USA, etc.) are either considering the use of international accounting standards instead of the local ones or have done it already.

The purpose of the given article is to explore, describe, compare and sum up the process of internationalization of financial accounting in Estonia. The research methods used comprised investigating specialist literature and valid international and local standard documents. In addition, the data received from a questionnaire about the influence of the latest amendments in acts on the administration of financial accounting in companies, where respondents were specialists in accounting entities, were used. Specialists’ opinion and estimates were used in drawing conclusions.

The focus of this paper is on the development of accounting regulation in Estonia within the framework of historical changes and cultural development. The reminder sections of the paper present creation the financial accounting system by three stages (Haldma, 2004) and conclusions follow.

The paper does not deal with broader topics such as the development of accounting practices in general or in particular industries.

Hopefully, this study will contribute to further optimization of accounting systems and management tools for business entities in Estonia.

2. THE APPLICATION OF FINANCIAL ACCOUNTING IN ESTONIA IN THE 20th CENTURY

As indicated earlier, history of accounting in Estonia has not been a subject of thorough investigation. There was very little information about the administration of accounting in Estonia until the early 20th century. Based on the history of the country we can assume that bookkeeping was probably performed in accordance with the accounting practice of the ruling country, which means according to Danish, German, Swedish and Russian practice in the given order. The Estonian accounting literature appeared only in the late 19th and early 20th century.

Alver, L. (2004), having researched bookkeeping in the Republic of Estonia (1918 - 1940), concludes that the standards, textbooks and instruction manuals that were valid in those days contain many aspects characteristic also of today’s market economy. The main document of those days was the Russian Trade Act accompanied by the Act of Golden Balances and the Language Act of Business Entities.

According to Šinman (1931), by the Russian Trade Act business entities were divided into three groups: banks and wholesale traders, retail traders and small-scale retail traders. The trade books that companies active in different fields have to keep and the rules for bookkeeping were determined. The compulsory trade books were given for the wholesale traders, retail traders and small-scale retail traders. Double-entry system was obligatory for the wholesale traders (not defined exactly but presumed), single-entry bookkeeping was allowed for the retail traders and small-scale
Tikk, J.

retail traders. All the books, obligatory for wholesale traders in those days are in use for contemporary businesses.

The Act of Golden Balances was enforced on January 1, 1926. According to the given act a common monetary unit became the basis for preparing the balance sheet - the Estonian mark. This act foresaw that fixed assets should be reported at the acquisition cost or at the construction cost in the balance sheet (similarly to contemporary approach). Subsequent revaluations (depreciation) should be reported at the capital side of balance sheet (contrary to current balance sheet layout). Abovementioned act defined that the evaluation of investments into securities should be reported either at the market value or at the disposal value.

The Language Act of Business Entities stated that only the Estonian language was to be used in bookkeeping starting from January 1, 1935. An exception was made for companies working on concession contracts, the majority of whose shares or stakes were owned by foreign companies or which functioned as affiliates of foreign companies.

During the Second World War Estonia had been under the German occupation from June 1941 till May 1945. At the beginning of the German occupation the entities had used both the regulations introduced during the republic of Estonia and the Russian (Soviet) accounting legislation. On 30 December 1942 regulations on accounting in Easter districts which stated framework for accounting under the German rules became effective. The most important amendments were as follows: the German language should be used for accounting, the “Reichmark” should became the common monetary unit, the double-entry bookkeeping should be taken into use (except for the small-scale retail companies).

After the end of the WWII, the occupation by Germany was replaced by the occupation of the Soviet Union. At the time when Estonia was part of the economy of the Soviet Union (1940 - 1941; 1945 - 1991) the administration of accounting and reporting was not easily understandable for others because there was no act regulating accounting and reporting. The latter was replaced by legal acts issued by the Council of Ministries of the USSR, Ministry of Finance, the Central Government of Statistics, etc., which were insufficient for the administration of bookkeeping but expressed ideological aspects. Accounting was centrally managed. Common regulations, common rules for accounting in institutions and enterprises were set, common accounting forms and documents were confirmed. Accounting principles of market economy, capitalist industrial relations, protection of private property and the possibility of establishing a common system or framework of accounting were criticized and ignored. In order to record economic transactions a lot of work was done by hand and it was time consuming. Recording economic events has gradually become more precise and systematic.

Before the 50ies the chronological recording of mass operations was practiced, which was really inconvenient. Starting from the 50ies transactions were already registered in journal orders only once, at the same time in the account debited and the one credited (Linnaks, 1983). From the late 50s the unified chart of accounts was created for most state organizations, except for banks, collective farms, cooperative trades and insurance companies. The most important task of the Soviet accounting was
to have control over planned economy. The data had to be as precise and objective as possible, creative accounting was strictly prohibited and punishable. The uniformed reports introduced the actual and planned results for the current period and the actual results of the previous reporting period.

From the aspect of market economy accounting in those days constituted a set of regulations for the mechanical recording of economic transactions, which was continuously amended, however, there was no compact system that could be used for making economic decisions. We can distinguish that under the Soviet accounting system

- Only financial accounting (bookkeeping) was introduced. There was no managerial accounting applied;
- Only tangible assets were included for accounting purposes;
- Only the historical cost method was used for recognizing assets.

During the Soviet system the double-entry bookkeeping was used with some exceptions of the collective farms and some small institutions.

3. TRANSITION TO MARKET ECONOMY AND CREATION THE BASIS FOR NEW ECONOMIC THINKING

The decline of the communist regime in Estonia created the basis for new economic thinking. The transition from planned economy to market economy involved radical changes in economy, including financial accounting. The Soviet accounting system was no longer appropriate for the informational needs of the managers. The main problem to face was how to build a flexible accounting regulation system, which would meet the challenges of 21st century to enable integration into and harmonization with the international accounting framework. Noticeable changes became possible after approving the Declaration of independence on August 20, 1991. Actually, the transition to market economy which began in the late 1980ies but was in full swing after 1990 meant the creation of a new accounting system.

At the same time the legal reform of accounting took place, which called for the preparation and enforcement of legal acts. On July 6, 1990 the accounting statute was approved by the Estonian Government and came into effect on January 1, 1991. Järve (2006) emphasizes the substantial changes arising from the statute, such as the use of terminology related to market economy, the replacement of cash-basis accounting by accrual-basis accounting, the structure of the financial statements in the annual report changed, the preparation of internal regulations for bookkeeping was required, etc. Passing the statute was the first step in the administration of financial accounting in accordance with market economy in Estonia and its implementation laid foundations for the introduction of financial accounting in conformity with the international accounting standards under the conditions of market economy. According to the statute the Accounting Standards Board reporting to the Ministry of Finance became an institution responsible for the administration of financial accounting, which gave methodological recommendations, prepared regulations, regulated reporting and solved organizational problems. However, the accounting statute was quite modest in content and volume.
From the specialist literature, Bailey (1998 p 1462) suggested for the countries in transition a phased approach to the accounting reform. Haldma (2004), analyzing the Estonian accounting reform and development of the Estonian accounting system, divided this process into three stages:

- Introductory (1990 - 1994);
- Creation of the system (1995 - 2002) and
- Development of the system (since 2003 onwards).

Haldma (2004 p 45) concluded that the phased approach followed in three directions: development of the accounting regulations towards implementation of the IFRS; development the scope of accounting regulations from private business to governmental institutions; development of the degree of independence of the accounting regulatory institution - the Estonian Accounting Standards Board.

During the introductory stage of the development of contemporary accounting system the main emphasis was laid on the regulation of accounting in business entities.

4. ESTABLISHMENT OF THE FINANCIAL ACCOUNTING SYSTEM BASED ON INTERNATIONALLY ACCEPTED PRINCIPLES

The accounting statute soon became obsolete. The rapid changes in economy brought along a necessity for the establishment of legal bases and main requirements for financial accounting in accordance with internationally accepted principles. The Estonian Accounting Board drafted the first Estonian Accounting Act which was enforced on January 1, 1995. In those days the act was largely conforming to the International Financial Reporting Standards (IFRS).

Since 1995 two sets of standard documents have been regulating the administration of accounting in Estonia. These are the Estonian Accounting Act and the Guidelines of the Accounting Standards Board. The Accounting Act is primary, its purpose is to establish legal foundations and to set requirements arising from internationally accepted accounting and reporting principles for accounting entities in the Republic of Estonia. The Guidelines of the Accounting Standards Board specify and explain the Accounting Act. The given documents laid foundation for the accounting system - the Estonian GAAP. 16 guidelines were worked out over time, which were then called the Estonian Accounting Standards; in addition, several recorded decisions were made, which were updated in due course.

Estonia signed an association contract with the European Union, which came into effect on September 18, 1995. The given contract stated that the approximation of the valid legislation as well as the one under creation to that of the union was a significant prerequisite for the integration of Estonian economy into the European Union.

The orientation in Estonia was and is to maintain the rules and regulations for accounting in conformity with the International Financial Reporting Standards, which required amendments in local standard documents in order to harmonize them with the International Accounting Standards. Thus, due to the changed conditions a new accounting act had to be worked out in Estonia, which came into effect on January 1, 2003. The basis was the accounting act that had been valid until that date, and which
had been well applicable in practice, nevertheless, it contained several remarkable shortcomings.

A large part of the former act was not applicable for accounting in the public sector; that mistake was corrected in the new act. The concept of a public accounting entity was defined, its obligation to prepare the annual report and consolidate it at the level of the state as one public legal entity was determined. By passing the act, the principles for financial accounting in the public sector that had developed in the member states of the European Union, were now implemented in Estonia, too.

The new act conformed concepts and basic principles, bringing them into accordance with IFRS. Some terms and definitions were added, on the other hand, several outdated ones were eliminated. For example, the definitions for revenue, expense, assets and liabilities were corrected. Unfortunately we have to admit that not all corrections were successful and there are some discrepancies and sometimes misinterpretations in definitions used in the IFRS, in the Accounting Act as well as in the Guidelines of the Accounting Standards Board (Alver, 2003).

According to the previous act the financial report consisted of two main statements (the balance sheet and the income statement) and notes. Now the annual report contains four main statements (the balance sheet, the income statement, the statement of cash flows, the statement of owners’ equity) and notes. Both the structure of the statements with small exceptions and the information disclosed in the notes has been conformed to the requirements of the IFRS and international practice.

The status of the Accounting Standards Board was changed. Now it is a functionally independent institution, which is administratively dependent on the Ministry of Finance, because according to the practice of developed countries accounting guidelines are issued by independent organizations. The Accounting Standards Board is administratively dependent on the Ministry of Finance. It was feasible to retain the administrative dependence in order to minimize costs.

The new act set the requirement that the Guidelines of the Accounting Standards Board have to be based on the IFRS, with references to the corresponding IFRS. If needed, it was allowed to determine differences, to simplify or not to imply the IFRS.

The new act presents additional requirements for a public employer, for a private or exclusive employer and for an employer providing services of general economic interest, the aim of which is to ensure the transparency of accounting in the entities mentioned in their financial relationship with the state or the local government. According to the joint position of the European Union Estonia was compelled to harmonize the above-mentioned directive with the Estonian legislation within the year 2002.

The previous act had included several articles, which were not applicable in practice, or were senseless or copied other laws. Such articles or parts of them were not included in the new act any more, such as asking for permission to transfer from one income statement scheme to another, asking for permission to maintain journals and ledgers electronically without having them in paper; the part dealing with the responsibility of an auditor and the responsibility for the administration of accounting. The latter two are provided by different laws.
The regulation of accounting in public institutions was under serious focus only from the creation of the system stage. The situation was analysed by the Ministry of Finance and the conclusion was that the existing regulations did not meet the expectations set for the public accounting system both from the aspect of internal and external users. The first Accounting Act almost did not touch upon the regulation of accounting in the public sector. However, the given field was regulated by the regulation of accounting for public institutions and decrees by the Minister of Finance. The accounting methods used were a mixture of cash-basis and accrual-basis accounting, and therefore the outcome was unsystematic both in content and in form. The lack of systematic methods also casts doubt upon the reliability of the data. Thus, we can claim that the state did not have a true overview about its assets, liabilities, accrual revenues and expenses. According to Jansen (2004) there were two parallel accounting and reporting systems - bookkeeping and fulfillment of the budget, whereas the latter was considered of primary importance. The mentioned systems did not have any logical connection. It was not possible to consolidate the data. Consistent information was available only in accounting for money earned and spent.

5. HARMONIZATION OF THE LOCAL FINANCIAL ACCOUNTING REGULATIONS WITH THE INTERNATIONAL ACCOUNTING STANDARDS

A new Accounting Act came into effect on January 1, 2003. Not only did the new accounting act bring the Estonian accounting legislation closer to the international standards, but also contributed to a better organization of the economic environment. The financial reports by business entities became more informative and enabled different interest groups to have a better overview about the reporting company’s financial position, assets and liabilities.

The new accounting act also applied to the public sector with a few exceptions. Accounting in the public sector was converted into accrual basis accounting and harmonized with the International Accounting Standards. The adaptation of the accounting act to public sector enterprises, including the local government ones, gave a remarkable rise in the level of financial accounting in the public sector. The change in the regulation of accounting at the state level led to reforming the accounting sector in the state as a whole. The new general rules for organization of the accounting and financial reporting of the state and the state accounting entities that became effective from January 1, 2004 was taken into use as the Estonian equivalent to the International Public Sector Accounting Standards. In the given stage the accounting principles in the public and private sector were harmonised.

According to the Accounting Act it was allowed all entities (excluding the listed companies) to prepare their statements either in accordance with the international standards (IAS/IFRS) or in accordance with the local guidelines. The Estonian GAAP, which are described in the Guidelines of the Accounting Standards Board (12 guidelines were enforced since January 1, 2003, at the same time the former guidelines and recorded decisions were declared invalid), are meant to be followed first by such companies who do not have to prepare their statements fully in accordance with the
IFRS. These are, for example, small and medium-sized enterprises. Although the Estonian GAAP is based on the IFRS, they allow for simplified treatments in certain fields and set fewer requirements for the information disclosed in the notes. The fact that Estonia joined the European Union on May 1, 2004 made it necessary to review the documents regulating financial accounting in Estonian companies.

Although Estonia has been ahead of time to a certain extent as according to the Accounting Act that has been effective since January 1, 2003 companies may prepare statements either in conformity with the International Financial Reporting Standards (IAS/IFRS) or with the Estonian GAAP, which were based on the international standards in principal, the local standard documents had to be amended due to changes in several international standards introduced in 2005.

The International Accounting Standards Board (IASB) changed about 20 existing standards, declared several interpretations of standards invalid and adopted a number of new standards. The amendment of the international standards was caused by the necessity to comprise areas that had been unregulated before, to decrease the number of alternative treatments, to eliminate possibilities of formal and malevolent interpretations (e.g. extraordinary items), reassess several terms and aspects (e.g. the treatment of goodwill).

According to the decision made by the European Commission all listed companies in the EU have to prepare financial statements in accordance with the IFRS starting from 2005 at the latest, for other companies the implementation of the IFRS is recommended. Thus, all the 17 Guidelines of the Accounting Standards Board were amended again. For now, all the Estonian local standard documents have been brought into accordance with the international standards, being actually simplified summaries of the latter.

On December 1, 2005 several changes were introduced in the Accounting Act. They emphasize the necessity of providing the users of financial statements with adequate information; transactions are allowed to be documented and journalized within a reasonable time period after the business transaction has occurred, whereas one has to take into account that statements have to be presented on time; the essence of journals and ledgers, the possibility of making excerpts and the requirements for the format of registers have been defined because the mechanical procedure of bookkeeping has changed due to computerization. An important change compared to the previous version is the provision of the implementation of internal control measures in internal regulations. The use of internal control is widely spread in the entities’ practice and obligatory for state institutions. The given amendment eliminates the respective loophole in standard documents.

A written declaration by the management is to be added to the annual report. The methods of accounting for the owners’ equity and its presentation in the consolidated statement are adjusted.

According to the amended act more information is required in the management report, such as the description of the main fields of activity as well as products and services; also the most significant investments made in the ending year and those planned in the near future. The accounting entities subject to auditing have to provide a macroeconomic analysis of their working environment, to disclose the seasonal or
cyclical nature of business activities, to describe the environmental and social effects influencing the business activities or caused by them, to assess risks arising from fluctuations in currency exchange rates, interest rates and stock exchange rates, to disclose the main financial ratios for the ending financial year and the methods used for calculating them. The introduction of these changes must ensure the preparation and presentation of financial statements in accordance with the generally accepted accounting principles, concerning particularly the unconditional observation of the disclosure principle.

The responsibility taken by those signing the annual report for the accuracy of the data presented is under focus.

The tendency is to simplify and generalize the main statements. However, several balance sheet entries have to be explained in detail in the notes to financial statements. Some amendments in the Accounting Act came into force on January 1, 2007.

The annual report states the entity’s field of activity according to the classification used for Estonian economic activities based on 10 most significant fields of activities. The management report is and will be a textual document written in a free form, where also the entity’s activities, product and service groups of the accounting year as well as those planned for the beginning year are indicated. Here the employers are not bound to the classification categories but may use them if they so wish.

Since November 19, 2007 the Accounting Act has been amended concerning the management report by an issuer of securities traded on the regulated securities market in Estonia or another member state (includes also the management report by a consolidated group). In conclusion, the idea of the amendments is following the disclosure principle in all economic transactions or events, where a business entity issuing securities is one of the parties.

The frequent changes in the international standards have caused real dissatisfaction among users, therefore the International Accounting Standards Board (IASB) made a statement in which they promise not to make any major changes in the Financial Accounting Reporting Standards until 2009. The pressure by the European Union on the given statement cannot be underestimated as the EU clearly expressed their dissatisfaction about too frequent changes in the IFRS (Vilu, 2006). The local documents are conformed to the IFRS and changes in the IFRS will cause changes in the local documents. According to the specialist questionnaire answers, frequent changes/amendments in acts are confusing for users and might cause mistrust in the legislative system. It would be better to work on acts for a longer time and more thoroughly, to discuss the projects and suggestions and only then make amendments. But in general, the users find the Estonian accounting system be satisfactory.

6. CONCLUSIONS

The transition to the market economy in Estonia starting from the late 1980ies actually meant setting up a new accounting system. At the same time a legal reform was performed in the field of accounting. Major changes were made in legislation, terminology, accounting principles as well as in financial reporting. A foundation was
laid for the administration of financial accounting based on the principles of a market economy in Estonia, which made it possible to implement financial accounting according to the international accounting standards.

By the implementation of those principles Estonia was a step ahead of other EU member states, implementing the international accounting principles already before they became compulsory for listed companies in 2005.

The changes made in the documents regulating the general administration of modern financial accounting can be divided into:

- Formal changes made for the clarity of the documents and to avoid misinterpretations;
- Changes of the content (incl. corrected terms and/or definitions, accounting methods and accounting principles added or changed, etc).

We can conclude that the reasons for changes introduced in the accounting act at the development stage of the financial accounting system are derived from the mistakes and inaccuracies occurred while dealing with financial accounting and preparing financial statements, and from possible misinterpretations of guidelines, contradictions between different acts, but also from the development of the general economic environment and information technology.

The harmonisation of Estonian standard documents and the international standards is necessary in order to reduce differences in financial statements and increase their comparability on the international scale.

The adaptation of the Accounting Act to public sector enterprises, including the local government ones, gave a remarkable rise in the level of financial accounting in the public sector. The change in the regulation of accounting at the state level led to reforming the accounting sector in the state as a whole. Now the accounting principles in the public and private sector are harmonised.

Since the accounting legislation and guidelines are based on the internationally accepted principles, the financial statements by Estonian companies are globally more understandable than the statements by companies located in several other countries. The developments in the field of accounting in Estonia have also attracted attention elsewhere in the world and several countries have either considered implementing the Estonian experience or have used the ideas.

The professional education and general level of financial specialists is rising in Estonia, however, people employed in the field of accounting have to be continuously provided with specialist training, also in theory. A strong theoretical background of the users of standard documents enables them to analyse documents, assess their user-friendliness and to solve technical problem based on theory.

By introducing the amendments in the legislation at the development stage of the system, Estonia has taken another step in the consistent development of the financial accounting system. The development is still continuing, because there are several areas that have not been dealt with or have been dealt with insufficiently, which, however, have to be regulated and updated in the development process of financial accounting.
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