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Accounting for Intangible Assets: Use of Relevant Accounting Standards

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ABSTRACT

Accounting practices of intangible assets like goodwill, patent, copyright, trademark, research and development differ from country to country. In Australia, Belgium, Brazil Canada, France, Germany, Sweden, USA, Japan and Netherlands, systematic amortization is found. Period of amortization varies from 5 to 40 yrs. In Hong Kong, Mexico, Nigeria, Italy, UK and EC immediate write off is more popular. In Switzerland no amortization is preferable. IAS and BAS provide that purchased goodwill may be amortized within 40 years but internally generated goodwill should not be amortized. Because there might be subjective valuation of market value of assets.

Introduction

Largest intangible asset is goodwill in modern business. Goodwill is the value of all favorable attributes that relate to business enterprise. These include exceptional management, skilled employees, high quality products, harmonious relation with labor unions. Goodwill is like investment, plant asset or patents which can be sold individually in the market place. It can be identified only with the business as a whole. Subjective valuations would never contribute to the reliability of financial statements. Good will is recorded only when there is transaction that involves the purchase of an entire business. It is the excess of cost over the fair market value of the net assets acquired. US companies are to amortize good will but UK companies need not amortize goodwill against earnings. Rather they charge goodwill to stockholders' equity as the accounting practices are different among countries; there is a strong debate over the ways of amortization. Intangible assets have no physical existence rather they represent certain legal rights and economic relationships. Patent, copy rights, leaseholds, goodwill trademarks, organization costs are examples.¹

The lack in current accounting systems lies in the fact that it cannot capture all important intangible values. This result in traditional income statements and balance sheets being misleading to investors and other users of financial information. Further, because great values in intangible assets are kept hidden in today's accounting, investors are compelled to make difficult assessments about these values in order to make their decisions. However, we do not find the solution in taking all intangible assets into the balance sheet at any cost. The important

qualities of today's accounting, such as reliability, cannot be jeopardized. Information about hidden intangible assets would therefore be better provided through some kind of alternative reporting. However, this kind of reporting has its errors in possibly being too subjective.²

Objectives of the Study

- (a) To know the various concepts of Intangibles and Characteristics thereon.
- (b) To analyze the nature of valuation and amortization of Intangibles with emphasis on good will.
- (c) To review the relevant literature in favor and against the use for amortization and valuation.
- (d) To assess the recommendations of IAS, BAS and FASB standard and practices of other countries in the said areas.
- (e) To arrive at concluding remarks for the debate of amortization or immediate write off in view of the existing theoretical framework and accounting practices followed.
- (f) To provide suggestions for developing the accounting practices for Intangibles based on international experience.

Methodology of the Study

The study is exploratory in nature based on secondary information. Extensive review of related studies has been done to find out the nature of treatment of Intangibles based on IAS, BAS and FASB standard.

Need for the Study

Proper accounting for good will is one of the most controversial issues in the field of accounting. Good will is the excess of the value of a firm over the aggregate value of its individual tangible and intangible net assets, value of an individual asset is calculated by its fair market value at the date of transaction. The traditional view of good will is that it is the discounted value of expected net income of a firm in excess of normal rate of return. Calculation of discounted value of expected income in the future might be less objective and confusing for the users, criteria of asset recognition show that right to future benefits, legal claim to the rights, benefits for the past transactions, opportunity for economic exchange etc., and good will can't be exchanged without transferring any other asset. Then it's questionable whether good will may be treated as asset or not. In this context there are different opinions regarding positive, negative good will, nature of treatment like immediate write off, systematic amortization etc. This study might be helpful in resolving the debate for the accounting treatment of good will based on different available accounting standards.

Review of Related Studies

Islam, M.M.³, had a study on "Accounting for goodwill and its modern review". He narrated the need for good will valuation, factors affecting value of goodwill, methods of valuation of goodwill, amortization of goodwill, modern reviews of goodwill accounting with due examples. He emphasized the fact that a distinction must be made between purchased

goodwill and non-purchased goodwill. He put arguments inform of following accounting treatments.

- (a) Write off the cost of purchased goodwill systematically against income.
- (b) We need not amortize purchased goodwill unless internally generated goodwill is capitalized.
- (c) Write off the cost of purchased goodwill as a special change immediately on acquisition.
- (d) The standard allows two treatments for purchased goodwill.

As the accounting standard board believes that there is no unique, correct method of accounting for goodwill, it may be written off directly against reserves on acquisition or be amortized over its useful economic life.

Choudhury⁴ wrote an article on "The game of goodwill". The accounting treatment of goodwill is one of the most debatable areas of financial accounting. Some accountants suggested that goodwill should be written off on the date of acquisition, some one feels that it should be carried to balance sheet, and written off systematically out of future revenues. The third group of accountants feel that it should be presented in balance sheet at a nominal value, others oppose that presence of goodwill in the balance sheet will do more harm than good to the users of financial reports.

Canning, chambers and spacek are in this group, Goldberg, Gythter, Eulenberg suggest that financial statements would be more informative if generated goodwill is presented in balance sheet. This is a very exciting game in accounting, goodwill is not tangible, not stable, not measureable not separable, not a producing element, not informative, not an asset to the users, it is acquired for future services.

Catlett and Olson have suggested that purchased and non purchased goodwill should be reported as an asset in the financial statements. However it is very difficult to give an appropriate answer to this debate.

Saha, Arabinda⁵ had a seminar paper on "IAS 38-Accounting for Intangible Assets: Accounting Treatments & Disclosures". This paper explains that the balance sheet provides next to no use in reporting the increasingly significant intangible assets of business entities. The author points out those intangible assets, such as a highly-talented workforce who generate more revenue, represent the major value-drivers of today's economy. The paper relates that attempts to modify the traditional accounting approach have not kept pace with the changes brought about by these intangibles. The author believes that the new rules penalize the companies, which have experienced a loss of value in their intangible assets through write-offs that immediately reduce earnings. The paper states that the best solution is to recognize intangible assets in the financial statement including the ones developed in-house; however, entities must report the future performance of their intangible assets or their earning potential before they are tested for possible impairment.

Austin Lioyd⁶ prepared an article on "Accounting for Intangible Assets". He saw that the development of an accounting standard for intangible assets has taken a long time, and it has been controversial. To understand the problems involved, it is necessary to look at the nature

of assets and the special case of intangibles. This article describes the nature of intangible assets. It gives an overview of the importance of intangibles and their characteristics which have made it difficult to formulate a standard. It describes the requirements of the IASB's International Accounting Standard 38. Accounting for Intangible Assets considers the consequences of its adoption. Intangible assets that are developed within the firm, the "internally-generated" intangible, have caused recognition problems. These assets are developed, usually over a period of time, within the firm and have traditionally been ignored, that is, not recognized in the financial statements. The importance of intangible assets has been the subject of scrutiny by investment analysts and academics.

Intangible assets have unusual measurement and recognition features which have made it difficult to develop a comprehensive accounting standard. The issue of IAS 38 in 1998 and its subsequent adoption by many countries from 2005 including New Zealand from 2005-2007 represents an attempt to impose a uniform set of rules on what had become an increasingly contentious and differentiated reporting environment. The approach of the standard follows that of the earlier research and development promulgations and imposes strict limits on the recognition of some assets, especially internally generated intangibles. The argument that there is a lack of a relation between the cost of the intangible assets and specific future revenues is also applicable to most property, plant and equipment assets. IAS 38 clearly excludes internally generated intangibles by rule rather than applying its recognition and reliability tests to these assets. Clearly the standard setters do not trust the valuation of intangible assets. Some relief is provided by the increased opportunities to recognize intangibles in other situations, for example in business combinations. Some of the provisions of IAS 38 are contrary to the established practices of some large firms and multi-nationals. These firms have been required to make major changes to their financial statements to reverse previous policies like the capitalization of self-generated intangibles which no longer qualify as assets. Some of these companies, like Lion Nathan and APN advocated strongly, to no avail, against the exclusion of their capitalized brands, mastheads and publishing titles using the argument that they provided relevant information that was also reliable.

Accounting standard setters are aware of the potential information gaps in the reporting of intangible assets both before and after the adoption of IAS 38. For example, the US Financial Accounting Standards Board added an enquiry "Disclosure of Information about Intangible Assets Not Recognized in Financial Statements" to its technical agenda in 2002. In similar vein, the International Standards Accounting Board has noted deficiencies and weaknesses in the guidance given by IAS 38.

Fadur, Cristina-Ionela and Ciotina Daniela⁷ had an article on "Is the Future of Accounting Compatible With the Accounting of the Future?" There is currently a tendency to reverse the relation between physical and intangible assets, in favor of the latter, which triggers the need to pay an ever higher attention to intangible assets. This article aims at presenting the relatively and inconsistency of the current accounting systems and does not claim to suggest an alternative conclusions.

Intangible assets are the most important resource that companies have in the process of value creation, but accounting balance in what concerns acknowledging, evaluating, and presenting intangible assets is only in an initial stage, in spite of the efforts made by national and international accounting bodies.

The accounting system has to extend its span at the level of intangible assets so as to truly reflect the economic reality. Intangible assets are the most important resource of the companies, especially those in the e-commerce field. The definition, the acknowledgement, the measuring, and the continuous evaluation- of intangible assets, as well as the presentation of financial information on the intangible asset represent the premises for obtaining valid, complete, and relevant information in decision making. The topic above is highly complex, and this material is intended only as an alarm signal, which records the relativity and inconsistency of the current accounting system, without claiming to suggest an alternative.

Krizova, Zuzana⁸ authored an article on "Accounting for Intangible Assets and Reporting Intangible Capital". He mentions that discussions about the role and reliability of information of the basic financial accounting statements continue to be evoked by bankruptcies of large companies or by the ongoing global financial crisis. Questions are often asked what causes the profound differences between the accounting and the market value of companies. Analyses and research results in this area often speak about very different ways of human capital management, differences in customer relationships, use of information technologies, employee knowledge or specific corporate organizational cultures. All these "invisible" resources have recently been named intangible assets or intellectual capital in literature. Intangible assets have been more and more interesting not only for researchers but mainly for company managers and owners. This contribution deals with differences in intangible asset statements pursuant to the International Financial Reporting Standards (IFRS) in comparison to the United States Generally Accepted Accounting Principles (US GAAP) and the Czech accounting legislation. The thesis also lists current views and trends, terms and definitions used in publications on intangible assets and intellectual capital. This article is based on analysis and comparisons of relevant literature resources, mainly articles and conference papers, but also legislative acts and monographs.

The differences in intangible asset reporting pursuant to the three abovementioned accounting systems also reflect in the indicators based on the financial statements, such as the asset return indicators and the equity return indicators. Regarding the volume of costs of research and development incurred by many companies the method of their reporting performs a significant role. In harmony with the trend of the growing share of intangible assets in the overall assets of the company it is also very desirable to achieve international comparability of the companies' economic results. The issue of harmonization of standards is currently resolved both on the level of harmonization of the national standards of the individual countries and IFRS, and on the level of harmonization of IFRS and US GAAP. The harmony between national accounting standards and IFRS within EU is to be achieved by the project of the Common

Consolidated Corporate Tax Base, which should be accomplished by 2011. EU would like to achieve a unified legislation for calculations of tax bases for the legal entity income tax calculation, with the rate to be specified by each Member State individually.

The International Accounting Standards Board, the issuer of IFRS, and the Financial Accounting Standards Boards, the committee responsible for the issue of US GAAP, signed a Memorandum of Understanding in February 2006. This document includes a sequence of steps to be taken to formulate quality and compatible accounting standards. The intangible asset area has not been included in the themes for short-term convergence but research and discussion in this area have been carried out nevertheless. At present the variability of recommendations for reporting elements that are not part of financial statements continues to grow. For that purpose various instruments in the form of guides, monitors etc. are produced. As my experience shows it might be beneficial to focus on extension of the "accounting technology", software, such as the extended Business Reporting Language (XBRL). If this reporting method was used the traditional financial statements might be complemented with tables with graphical symbols, different color codes etc.

Daum, Juergen H.⁹, had an article on "Intangible Assets: The Art of Creating Value". The success of companies no longer depends upon production facilities, financial capital, and ownership, but more and more upon immaterial values, known as intangible assets. Such assets include not only relationships with business partners, brand awareness and new business ideas, but also know-how, corporate culture, and the ability to innovate. Today, identifying, valuing and managing immaterial assets is becoming increasingly important for companies. How can companies recognize and use the potential offered by intangible assets? In a conversation with sapinfo.net, Juergen H. Daum explains the function of intangible assets in enterprise management.

Arkblad Liseloth and Carolina Milberg¹⁰ had a study on "Accounting for Intangible Assets - Relevance Lost?". Intangible assets are getting more and more important to companies and their owners. The reason for this is that the economy has changed from being industrial to knowledge-based. It is no longer the industrial value chain that creates value, it is innovation and constantly seeking new ways of meeting market demands. Companies can no longer differentiate themselves or create competitive advantages without intangible assets. With increased importance of values in intangible assets, the need for financial information about companies has changed. However, current accounting systems have not been able to keep up with this development. Because of the uncertainty connected with intangible assets, accounting cannot capture their increasingly important value. Consequently, investors and other users of financial information are not provided with sufficient information to make good decisions. This poses the question whether relevance has been lost in accounting for intangible assets? Further, because of this possible lost of relevance, perhaps alternative approaches on reporting of intangible assets are needed.

Monem¹¹ in a study on Accounting for Goodwill found that still today appropriate accounting for goodwill remains to be one of the most controversial issues in accounting. Several accountants had advocated variety of treatments most of which are abandoned. In this paper some suggestions for proper accounting treatments are made which deserve good theoretical support. It is suggested that only purchased positive goodwill be recorded at the difference value and immediately written off from stock holder's equity. This approach is recommended because it is less ambiguous, more objective and consistent. This recommendation is consistent with the suggestion of not recording internally developed goodwill. For negative purchased goodwill it is suggested that it should be recorded as unrealized gains, if eliminated from the balance sheet by offsetting against future earnings.

The major characteristics of intangible assets are¹²

- (a) They lack physical substance.
- (b) They are not financial instrument.
- (c) The cost of purchased intangibles is capitalized because its cost can be objectively verified and reflects its fair value at the date of acquisition.
- (d) Once intangibles are created internally, future service potential calculation is difficult. There arises the question of subjectively because management can argue that any expense could be capitalized in the sense that it will enhance future benefits.
- (e) Tends to have relatively long lived.
- (f) Usually do not have residual value.

Factors Considered in Measuring Useful Life of Intangibles¹³

- (a) The expected use of the asset by the concern.
- (b) The expected useful life of another asset or group of assets to which the useful life of the intangible may be related.
- (c) Legal, regulatory or contractual provisions limiting useful life.
- (d) Such provisions for renewal or extension of the asset.
- (e) Nature of obsolescence, demand, completion and other economic impact.
- (f) Maintenance expenditure needed to have the expected future cash flows from the asset.

Nature of Amortization

We know that the amount of amortization expensed for limited life intangibles should indicate the pattern on which the asset is consumed. If the pattern can't be determined, the straight line method of amortization is used. Trade mark as intangible has an indefinite life and it should not be amortized. Intangible assets having pictures, photographs, video and audio video materials, are protected by copy rights contract. Related intangible assets are the value of rights that arise from contractual arrangements like Franchise, licensing agreements, construction permits, etc. The amortization period of intangibles in conformity with matching principles is based on legal, contractual or economic factors / combination of them etc.

Various Concepts of Goodwill¹⁴

Goodwill is the excess of cost of an acquired firm or separate operating entity over the current market value of its identifiable net assets. By identifiable net assets we mean excess of assets over any liabilities assumed at the date of purchase. When part of the total purchase consideration cannot be related to particular assets, it is taken as goodwill. It has value because it shows the price given as per cost principle for exceeding normal profit performance. In case of unidentifiable goodwill, it can't be separated from the enterprise. Costs incurred in such case of internally developed goodwill cannot be capitalized.

Impairment of Value of Intangible Assets

It happens when the book value of an intangible asset exceeds its economic value. The book value must be written down and an impairment loss should be recognized disclosure though note is also required.

Classification of Intangible Assets:

- (a) Identifiability
 - (i) Identifiable have specific identities and can be sold separately such as patent copy right or franchise, trade mark etc.
 - (ii) Un identifiable - cannot be separated from the entity; the primary example is goodwill.
- (b) Manner of acquisitions -
 - (i) Externally - Acquired from external sources.
 - (ii) Internally - Developed within the company.
- (c) Expected period of benefit -
 - (i) Limited period of benefit - It may depend on legal contractual or economic factors.
 - (ii) Indeterminate life - It tends to be the major characteristics of goodwill of a business.

Approaches to goodwill¹⁵

Measurement definition shows that goodwill is measured initially as the excess of fair value of the acquisition cost over the fair value of the net assets acquired. Goodwill is sometimes taken as unidentifiable intangible assets, not readily measurable. This covers new channels of distribution, synergies of combining sales forces, contribution of superior management team etc. Goodwill is the intrinsic value; a business acquires beyond the value of net assets, due to reputation, locational value, personality of management people, etc. Sometimes capitalized value of the excess of estimated future profits of a business over the normal rate of return on capital invested is taken as goodwill.

Negative goodwill arises when the fair value of the asset purchased is higher than the cost. This happens once a company fails to produce sufficient earnings to sustain a value on the business as whole equal to the value of its separate resources and property rights. The value of goodwill is subjective and should not be given some status like cash, receivables, inventory etc. Presentation of good will in balance sheet does not show any useful information to the users. Once payment for

goodwill is made but written off immediately, it denies that it has no value.

Relevant Accounting Standards¹⁶

The accounting standards require that if the carrying amount of such assets may not be recoverable then the carrying amount of asset should be assessed. Recoverability test is done comparing the sum of the expected future cash flows to the carrying amount. If the cash flows are less than the carrying amount, the asset is impaired. The impairment loss is measured as the amount by which the carrying amount exceeds the fair value of the asset. The fair value of asset is measured by then market value assuming an active market for the assets. If no market is available, the present value of the expected future net cash flows from the asset may be followed.

The objective of IAS 38 is to prescribe the accounting treatment for intangible assets that are not dealt with in other standards. It requires an entity to recognize an intangible asset if certain criteria are met. It shows the ways to measure the carrying amount of intangible assets and the nature of the disclosures to be given.

Recognition criteria as per standard 38 -

It is probable that future economic benefits from the asset will flow to the entity. The cost of the asset can be measured reliably once the relevant expenditure can't be measured reliably, expenditures like training costs, advertising, promotional activities, relocating activity etc. should be taken as expense. Separately acquired intangibles like brands, licenses, computer software, patents meet the recognition criteria. It should be recognized at cost. Cost includes the net amount paid for the asset after taxes, trade discounts, direct attributable costs etc. Other costs like professional fees are taken as administrative and overhead costs.

The cost of an intangible asset collected in business combination is assessed at fair value at the acquisition date. Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. It is observed from active market or recent similar transactions.

Internally Generated Intangible Assets:

It should not be recognized as an asset as per IAS 38.

Conclusion

Intangible assets are accounted for at cost and should appear on the balance sheet in the intangible section at cost or at that portion of cost not previously written off. Intangibles should be systematically amortized to expense accounts over their estimated lives but that should not exceed 40 years. Amortization is a process similar to recording of depreciation. Virtually, amortization of intangibles is limited to the straight line method unless it can be shown that other method is more logical. Sometimes patents, copy rights lease holder have specific lives based on law / contract. The costs of such assets should be amortized over the shorter of their legal existence or the period of benefits through use. Reasonable estimate of the useful period is important. Their costs

can be amortized over the periods of benefits to be enjoyed but not exceeding 40 years.

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AN ANALYSIS OF CORE FACTORS CONTRIBUTING U.S – CHINA TRADE IMBALANCE

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ABSTRACT

This paper aims to highlight the trade imbalance between United States and China based on the analysis of core factors contributing the imbalance. These factors are comprises of trade inequality, exchange rate issue, difference in basic economic structure of both the countries, and methodology of calculating trade figures. This paper also highlights that where both the countries differ in their point of view on their bilateral trade and why? Beyond doubt this imbalance leads United States to face huge deficit and China to enjoy the giant surplus in mutual trade. Now, how can we adjust the figures and narrow down the differences? The paper is also discussing the other issues which have reasonable implication on U.S -China trade relations. It also enumerates the future consequences on their bilateral trade keeping in view the current scenario. The importance of this paper is further enhanced as the trade imbalance is also counted as one of the factors of 2008 recession which is not yet fully over because there is very slow recovery in developed countries and relatively faster in developing countries. The analysis is based on the U.S trade data from 2001 to 2010.

Keywords: Imports, exports, Exchange Rate, Economic Structure

INTRODUCTION

United States is considered as the world's most developed country and has been the leading exporter of the world. But first it was pushed back by the Germany and now outclassed by China. Once General Motors was the world's largest company but in year 2007 Toyota Motors from Japan replaced it with higher production and became the world's largest Automobile manufacturer. Moreover, in the year 2008 China became the world's biggest market for automobiles overtaking United States. United States dollar is loosing its value and Euro is more in circulation in the market than U.S dollar. For the first time in history the United States trade deficit reached \$268 billion in trade with China in 2008. China has gained the status of third largest trade partner of United States after Canada and Mexico and has emerged as the fourth biggest economy of the world. China is still behind Canada and Mexico by huge margin as United States has free trade agreement with these countries. The total trade deficit of U.S reached its peak in 2006, although it started contracting in 2007 and 2008 but it continues to rise with China (See Table 01). In recent years China's increasing trade surplus is a matter of unrest for U.S but it is not a hard nut to crack.

There are some implications and technical factors which influence this trade imbalance. Researchers from the world over and the Government agencies of both the countries have extensively worked out this problem from different dimensions, in continuation of this we have also discussed some core factors in detail in this paper. First, there is a difference in basic economic structure of both the countries as United State's economy is services oriented economy and China largely depends on the secondary goods manufacturing. As a result the goods exported by China either do not produce in United States or if produce, are less than domestic demand. Second the regional relocation of foreign firms in China. Since the foreign firms are entering in China and difference in the nature and structure of economy has magnificently boost the manufacturing and industrial growth. Increasing FDI from neighboring states like, Japan, Taiwan (China) , South Korea etc, which has laid the exports figure higher and higher. The main reason behind this relocation is to avail the comparative advantage of labor and subsidized resources. Third the discouraged U.S' high tech goods exports to China. Particularly this problem can more easily be handled if the trade between United States and China is made without discrimination and on the basis of equality. Otherwise, this issue is proving to be less economic and more political due to selected exports to China and protectionist policies adopted by U.S. The other controversial issues like; China's downward manipulation of Yuan, the emergence of China as the biggest creditor to U.S, United State's weak control over its financial system? And increasing intervention of foreign central banks especially China and Japan has caused financial collapse and trade imbalance of United States. In the context of some exchange rate regime Analysts including David Pilling, the Asia editor of the Financial Times, and Brad Setser, an economist formerly at the Council on Foreign Relations and now at the National Economic Council, argue that far from a sign of strength, *"Beijing's accumulation of vast foreign reserves is the side-effect of an economic model too reliant on exports."* Writes Pilling:

"The enormous trade surplus is the product of an undervalued [RMB] that has allowed others to consume Chinese goods at the expense of the Chinese people themselves. Beijing cannot dream of selling down its Treasury holdings without triggering the very dollar collapse it purports to dread. Nor are its shrill calls for the U.S. to close its twin deficits—which would inevitably involve buying fewer Chinese goods—entirely convincing. Rather than exposing the superiority of China's state-led model, the global financial crisis has laid bare the compromising embrace in which the U.S. and China find themselves"

2. PRESENT SCENARIO

2.1. TRADE BY VOLUME

In recent years China has emerged as the third largest exporter of all goods and services in the global economy followed by Germany and the US -In 2006, China accounts for around 7% of total world trade. By 2030 it is expected to rise to 15% (*et al Sarah, 2005*). More than half of China's exports are currently capitalized by foreign companies. Most of this capitalization comes from neighboring Asian companies in Japan and South Korea. United States and China are major trade partners, China

stands third biggest trade partner of United States after Canada and Mexico and on the other hand United States is top trade partner to the China. The Chinese trade surplus started to rise from 1985 and touched the highest point in 2008.

Although China does not enjoy any free trade agreements with United States like Canada and Mexico yet the percentage rise change in the trade of United States with China during 2000 to 2007 has been recorded as is 301%. However, which has risen by only 44% with rest of the world during same time period it is only 44% with the rest of the world during the same period (*U.S Census Bureau 2008*). This volume is continued to rise until 2008 recession, when financial crisis collapsed the U.S financial market and affected the global economy severally rest of the world. This increasing trade deficit was ignored by the U.S consequently could not focus the bilateral trade and it continues to add to deficit.

Table 01: U.S China trade history since, 2001

Year	Exports	Imports	Difference
2010*	27,738.6	98,754.8	-71,016.2
2009	69,496.7	296,373.9	-226,877.2
2008	69,732.8	337,772.6	-268,039.8
2007	62,936.9	321,442.9	-258,506.0
2006	53,673.0	287,774.4	-234,101.3
2005	41,192.0	243,470.1	-202,278.1
2004	34,427.8	196,682.0	-162,254.3
2003	28,367.9	152,436.1	-124,068.2
2002	22,127.7	125,192.6	-103,064.9
2001	19,182.3	102,278.4	-83,096.1

SOURCE: U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, Washington, D.C. 20233

NOTE: All figures are in millions of U.S. dollars, and not seasonally adjusted unless otherwise specified. *till April 2010

2.2. GOODS TRADED

China's major exports to United States include electric machinery, power generation equipment and games & toys. Whereas United States' main exports to china include Computer & equipment, transport machinery, chemical and scrap. If we analyze the percentage change in exports goods to United States, steel and plastic articles are at the top Chinese exports to US where steel exports alone increased by 24% in the year 2008 as compared to previous year 2007 and slightly decline in 2009. The goods traded between China and United States does not reflect the trade equality, especially when it comes to high tech trading, the Chinese high tech exports rose by 10% over the period but its only 3% by the United States over the same period. The special case is of Aircraft and Spaceships, which shows 29% decline over the period (*China's Customs Statistics*). As we see that Canada is the biggest trade partner of United States and high tech goods have reasonable proportion of their trade if same pattern is adopted and United States allow China to import the same high tech goods with lower tariffs and increasing quota can reduce U.S trade deficit. This issue is considered as less economical

more political.

2.3. PROPORTION IN WORLD TRADE

In recent years, Western business and political leaders have voiced concerns that China’s economic rise is posing severe competition. They generally identify two types of threats: a quantitative and a qualitative. First, there is a perceived quantitative threat related to China’s stellar export performance. Since 1992, China’s exports have grown at an annualized rate of 18 percent, more than twice the growth rate of world exports. As a result, its share of world exports has surpassed that of Japan to become the world’s third largest in 2008, after United States and Germany. This has garnered the fear that China is eating away Western countries’ market shares. Second, there is a perceived qualitative threat that the goods that China exports are becoming increasingly sophisticated. Where fifteen years ago China was primarily an exporter of low-tech products such as apparel, toys and footwear, today it has become the world’s largest exporter of electronics products. This has caused concern that China is rapidly moving up the technology ladder and becoming competitive in areas of comparative advantage for Western economies (*Chang Hong, 2008*).

United States is still a world’s largest economy as for as trade is concerned, and china comes at 4th number. Now keeping in view the China’s increasing share in world trade and its rapid access to Asian and European markets, after the United States, Japan, South Korea, Germany, Australia, and Russia its main trade partners. The volume of trade is increasing over the period with trading partners both in Imports and exports (See table:2). Now as a result United States is loosing its trade share gradually in these regions. After the financial collapse U.S economy is facing dual trade loss first at its domestic and then rest of the world. The negative saving ratio has made the situation more severe.

Table 02: Top U.S and China export markets by volume

Top US Export Market by Volume			Top Chinese Export Market by Volume		
1	Canada	\$ 204.7 billion	1	United States	\$ 220.8 billion
2	Mexico	\$128.9 billion	2	Hong Kong	166.2 billion
3	China*	\$ 69.5 billion	3	Japan	\$ 97.9 billion
4	Japan	\$ 51.1 billion	4	South Korea	\$ 53.7 billion
5	U.K	\$ 45.7 billion	5	Germany	\$ 49.9 billion

Source: US Department of Commerce, US International Trade Commission & PRC General Administration of Customs, China's Customs Statistics.

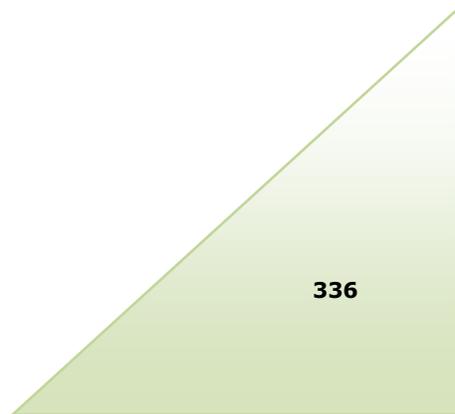
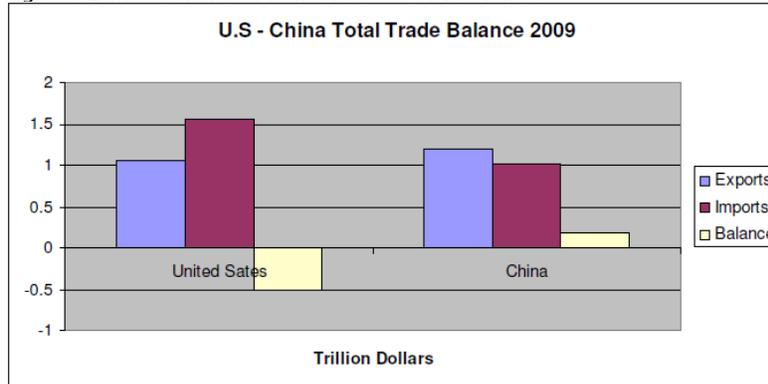


Figure: 1 U.S and China individual net trade balance



Source: U.S Census Bureau and China Statistical Yearbook, 2009.

3. ANALYSIS OF CORE FACTORS

3.1. TRADE FIGURE DIFFERS ENORMOUSLY

Both the countries are agreed that there is trade imbalance between both the countries but there is a contradiction in how big the imbalance is? The different figures are quoted while calculating the trade statistics. So there is a large and growing difference between the official trade statistics released by the United States and those released by People's Republic of China. According to the United States, the 2009 bilateral trade deficit with China was \$226.8 billion. According to China, its trade surplus with the United States was \$143.273 billion—\$83.5 billion less than U.S recorded figure (See Table: 3).

Table: 3 list the official trade statistics from the United States and China for the years 2001 to 2009, using official trade data according to both the countries; the U.S. trade deficit with China is large and growing. Where the two sides differ is how big the deficit is and how fast it is growing.

From the U.S. perspective, its bilateral trade deficit with China more than tripled in value over the last eight years, from just over \$83 billion in 2001 to over \$226 billion in 2009. However, from the Chinese view, its bilateral trade surplus with the United States increased more than six fold over the last eight years, from about \$28 billion in 2001 to nearly \$143 billion in 2009.

Many individuals and agencies tend to trust the U.S statistics because collecting and summarizing data accurately is not an easy job. As china is a developing country is probably less able to do this job as compare to United States which is advanced and developed country. But it is still a question? Infact, neither figure is accurate as different statistical and counted method is used by different countries for calculating exports and imports. For example while calculating the F.O.B (free on board) it includes production and as well as the cost of production of goods and loading them on to the cargo vessels which is generally followed by all countries but except United States. United states calculate it F.O.B less loading. Another principle is imports and exports should be calculated

with same base such as, F.O.B. Hong Kong re-export make the problem more complicated. Initially goods are shipped to the Hong Kong subsequently re-exported to the different destinations including United States and China (mainland). Buyer in Hong Kong takes legal possession and can undertake minor processing. For china it's not clear that how successfully the government is tracking down the origins and final destinations of goods. For U.S reports, imports are assumed to be accurately recorded including re-export through Hong Kong and exports probably do not include those through Hong Kong re-export.

Table 3: U.S. and Chinese trade figures, 2001-2009
(Billion U.S. dollars)

Year	U.S. Trade Figures			Chinese Trade Figures		Trade Balance
	Exports to China (F.A.S.)	Imports From China (C.V)	Trade Balance	Exports To United States (F.O.B)	Imports From United States (C.I.F)	
2001	19.235	102.280	-83.045	54.277	26.204	28.073
2002	22.053	125.168	-103.115	69.959	27.228	42.731
2003	28.418	152.379	-123.961	92.510	33.883	58.627
2004	34.721	196.699	-161.978	124.973	44.653	80.320
2005	41.837	243.462	-201.625	162.939	48.735	114.204
2006	55.224	287.773	-232.549	203.516	59.222	144.294
2007	65.238	321.508	-256.270	232.761	69.861	162.900
2008	71.457	337.790	-266.333	252.327	81.486	170.841
2009	69.576	296.402	-226.826	220.706	77.433	143.273

Source: World Trade Atlas, U.S. International Trade Commission

3.2. HUGE GAP IN SERVICE TRADE

Services trade is an important element of international trade and china is a net importer of services and deficit has increased since 1990's, on the contrary United States is a World#1 exporter and importer of commercial services and a net exporter. The U.S services trade surplus with China was \$ 5.4 billion in 2007. In this regard United States has privilege to lessen the merchandise trade deficit with China through encouragement of services trade. If we take a glance of GDP configuration of both the countries by sector, United States' services sector comprises 76.9 % of GDP and only 40.5 % for China. It reveals that U.S economy is more competitive than Chinese and shows the high innovative and standard. For china its merchandise trade is much more important as its industrial sector composes of almost 50% of GDP, but for United States merchandise trade has relatively small portion as compared to the services sector trade.

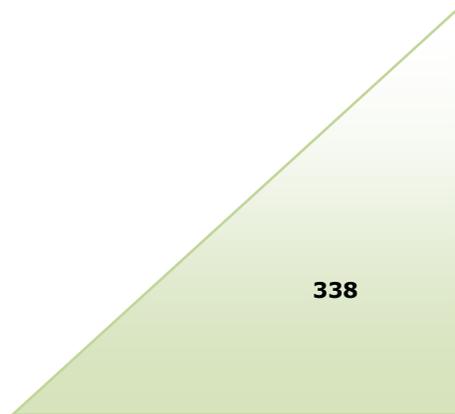
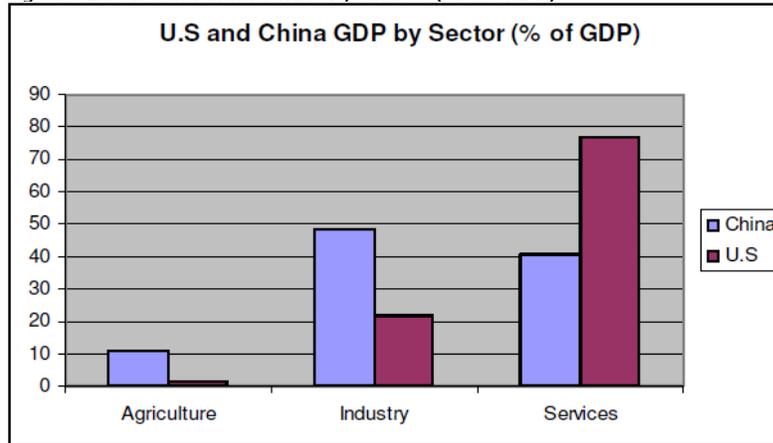


Figure: 2. U.S and China GDP by sector (% of GDP)



Source: China Statistical year Book & U.S Census Bureau, 2009

3.3. DIFFERENCE IN BASIC ECONOMIC STRUCTURE

Since United States and China represent different economic categories consequently have different economic structure. China represents emerging economies and counted amongst the developing countries category. China is still a transition economy with many perverse incentives in the much diminished but still significant state-owned enterprise (SOE) sector, and the monopoly state banking system. The existence of these perverse incentives, it efficiently handled through quantitative targets enforced by administrative means than through the impersonal price mechanisms in these particular markets. It is aware, of course, that we are talking about using what are usually regarded as "second-best" economic policies to address some of China's macroeconomic challenges, and that this is a path well-trodden by deregister states toward the slippery slopes of economic mismanagement (*et al, Wing, 2005*). Chinese policy stance is based on their assessment market oriented practices are yet not the norm in many parts of Chinese economic life, and that it would be ideological rather than analytical to be a market fundamentalist in economic management. Freemarket policy tools work well only in a free market economy, and China is not yet fully a free-market economy. China is basically a partially reformed economy and striving towards liberalization. Chinese economy mainly produces secondary goods and heavily relies on it. Most of the technology and services are imported from the developed countries like United States, Japan, Germany and South Korea etc. Chinese comparative advantage lies in cheap labor and tendency of low price is the leading factor in determining its fast growing share in global trade.

United States economy is fully equipped economy and considered as the world's most advanced economy. So their economy has no primary industry, relatively small portion of secondary sector and huge tertiary (service) sector. As we already discussed in previous paragraph, it

represent about 80% of total GDP. It is because as the countries grew richer their demand shifts away from the traded goods (such as food, clothing, and manufactures) towards non traded goods (such as housing, healthcare, education and other services). It has taken place in United States: the share of personal consumption expenditure devoted to the services has risen steadily in recent decades at the expense of expenditure on durable goods and non durable goods. This evolution of demand has shifted in the configuration of U.S economy away from the production of the merchandise goods towards the production of services. (The more rapid productivity growth in goods-producing sectors, which has diminished the price of goods relative to services, has also contributed to this result.) As a result, the traded goods sectors of the economy—specifically, agriculture, mining, and manufacturing—have declined over the time (*Irwin, 2005*).

So this is a normal behavior of economies when they enter from one phase to another there are some structural changes which take place and same happened in U.S and Chinese trade. United States import most of merchandise goods which it either doesn't produce or produce at small level. People spend more on services rather than on durable and non durable goods. On the other hand Chinese economy heavily depends upon the secondary industry mostly include mining, manufacturing, production and construction etc.

3.4. EXCHANGE RATE (DOLLAR-YUAN)

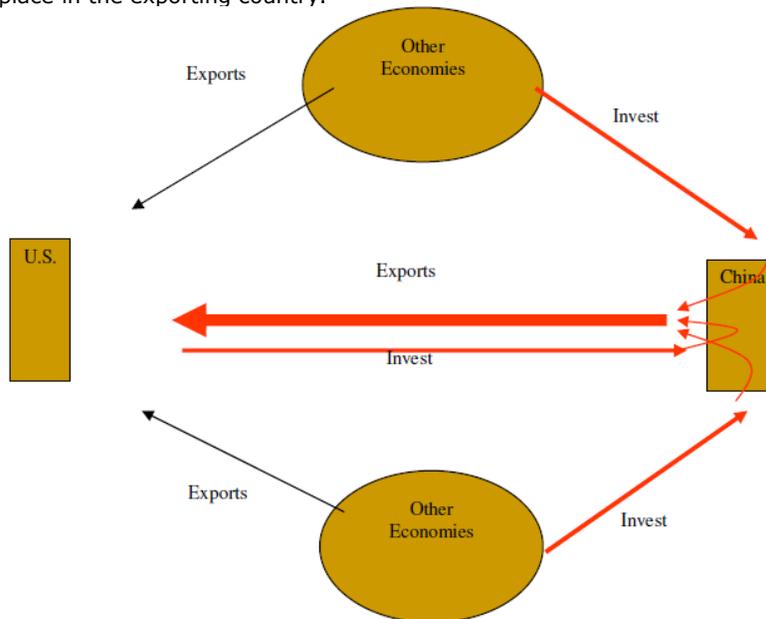
United States blame that Yuan is manipulated and is undervalued, now question arises that, who will benefit from the rise of Yuan? This is very critical issue because china does not want to take risk at the cost of growth rate which it thinks it's imperative to maintain at 10%, and valuable exports share in the world market. The 20% appreciation of Yuan will reduce the U.S trade deficit by \$40-55 billion and simultaneously help China to reduce the agriculture good deficit in which U.S has surplus and as a result China can import more wheat and corn. It can also bring competitiveness in china's agriculture which may hurt farmers but benefit consumers.

For dollar the suggestion like, "The huge current and trade deficits of the United States cannot continue indefinitely because doing so would develop a permanent gift to the U.S. economy. The process that will cause this gift to shrink and that will eventually cause it to reverse is a reduction in the value in the dollar. The dollar will lose value as private investors and governments become unwilling to accept the risk of increasing value of dollars in their investments, especially in a context in which they realize that the dollar must fall to reduce the trade imbalance. Although a more competitive dollar is the mechanism that will because the U.S. trade deficit to decline, the basic requirement for a lower trade deficit is an increase in the U.S. national saving rate. So a rise will be driven by higher household savings of the coming years as the two primary forces that depressed savings in recent years are reversed: the exceptionally rapid rise in household wealth and the high level of mortgage refinancing with equity withdrawal. (*Martin S. Feldstein 2008*).

3.5. FOREIGN INVESTMENT FIRMS IN CHINA AND EXPORT PROCESSING

Foreign investment firms in China have substantial proportion in the exports and played significant role in export volume. Large number of foreign investment firms are involved in processing trade especially those with investment by businesses in the neighboring economies. While china is having increasing rising trade surplus with the U.S it is running increasing trade deficit with some neighboring economies including Korea, Japan and Taiwan, part of increasing trade surplus with U.S is a result of these regional manufacturing relocations.

A particular characteristic of China's exports is the large importance of export processing trade. Since China's Opening Up in 1979, China has set up a number of export-processing zones along China's coastal region to attract foreign investment and technology transfers. As many companies from North America, the European Union, Japan and the Newly Industrialized Economies (Singapore, the Republic of Korea, Hong Kong and Taiwan) moved their labor-intensive assembly plants to China in a bid to cut production cost, this has led to a rapid rise in China's export-processing trade (Naughton, 2007). The large role of export-processing trade may have been significantly biased upward the perceived competitive threat from China. International trade data are generally collected and reported as gross flows rather than as value added created in the exporting country. As a result, a country's exports do not necessarily reflect accurately the production activities that take place in the exporting country.



Source: Author

Protectionism

In the United States, the 109th U.S. Congress introduced 27 pieces of anti- China trade legislation. And the current 110th U.S. congress introduced over a dozen in just its first three months in office (Scheve and Slaughter, 2007).The protectionism policy will further hurt the U.S economy rather than to improve. The great depression and current global crisis have close similarities as both start with sharp assets price fall and near collapse of financial system, both are global in reach, fall in stock price then housing prices while increasing uncertainty in consumers and business. The substantial fall in demand, consumption and investment affect the GDP. The protectionism can not be the intention of United States as it has already a lesson from great depression. This time it means that U.S alienate the rest of world which will affect the investment in U.S treasury as foreigners will sell all the holdings overnight and can cause panic.

4. CONCLUSION

In this paper I have demonstrated that U.S - China trade imbalance is not a matter of much concern because it is obvious when economies pass through the evolution (from Underdeveloped to developing and developed) their behavior changes, just like in case of China, its economy is undergoing the transformational processes and will assess and rectify itself with the passage of time. Therefore, owing to difference in economic structure and basic constituents, the increasing demand for Chinese goods in U.S is for those goods which U.S either don't produce anymore or less than its domestic demand. Chinese surplus is solely spread over the merchandise goods. However, U.S can balance this through services trade, military and high tech goods exports which are either banned for china or quota is imposed. As a result United States should move out of preferential trade zone like NAFTA and EU and should broaden the circle of free trade which is in its interest. The strong criticism from the US and the increasing pressure for exchange regime reform may not be very well-grounded as the trade figures are distorted due to various factors. This is obvious and economic principle when dollar will be higher than its subjected value will tend to enhance the risk for investors and government eventually, it will move downward to attain the balance which will further help to reduce U.S trade deficit. The exchange rate is not only a factor of imbalance, the regional manufacturing relocations, and export processing of foreign firms is also one of the factors. The huge inflow of FDI is contributing to China's GDP and international trade Moreover, U.S saving rate must be increased and dollar must revalued. The trade relations should not be politicized and should refrain from imposing quotas and duties which hurt bilateral trade relations and cause gap. In general the trade disputes are better solved through cooperation. Strong and harmonious trade relation are in the interest of both. As there is a huge difference in bilateral trade data. Now, in order to calculate the Trade Data, both countries should adopt the similar statistical method as to avoid the errors and double counting especially in case of Hong Kong.

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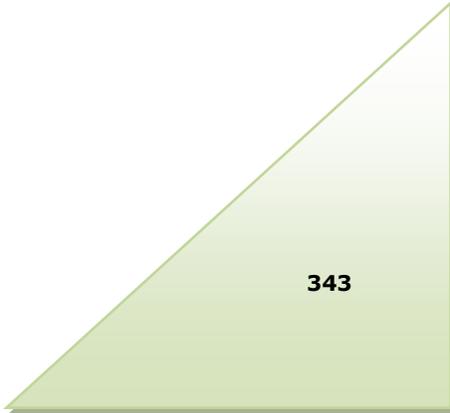
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CAPITAL STRUCTURE DETERMINANTS: EVIDENCE FROM MANUFACTURING AND SERVICES SECTOR COMPANIES IN SRI LANKA

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ABSTRACT

This paper develops a preliminary study to explore the determinants of capital structure of Sri Lankan listed manufacturing and services sector companies using firm level panel data for the period of 2003 – 2007. Profitability, Tangibility, Size and Growth rate were used as independent variables, while leverage ratios such as total debt ratio, long term debt ratio and short term debt ratio were the dependent variables. OLS dummy regression model was used here. The results revealed that only profitability variable was statistically significant with leverage ratios (with total debt ratio and short term debt ratio) at manufacturing companies. Meanwhile all the selected variables, except tangibility were significantly related with at least one of the leverage ratios in services companies. Results of this study validate the prediction of pecking order theory in the case of profitability variable in both manufacturing and services companies. Also growth variable of services companies again confirms the pecking order hypothesis. However size variable of services companies confirms to prediction of trade-off and agency cost theory.

Keywords: Capital structure, Leverage, Manufacturing companies, Services companies.

INTRODUCTION

This paper provides further evidence of the capital structure theories applicable to a developing country and examines the impact of the lack of a secondary capital market by analysing a capital structure question with reference to the Sri Lankan financial environment. The theories of capital structure are among the most interesting in the field of finance. They give explanations in questions like how much companies should borrow, what is the relationship between capital structure and company value, how companies choose their capital structure, and so on. Even though there is no exact formula available for the establishing optimal target debt and capital ratio, empirical studies indicate that profitability, types of assets, taxes, differences across industries, uncertainty of operating income, liquidity, etc. should be considered when formulating capital structure policy. Does an optimal capital structure exist? What are the potential determinants of such optimal capital structure? These are the questions to be answered by a researcher. However, most of the research work has been carried out in developed economies and very little is known about the capital structure of firms in developing

economies. With this little research, we are not sure whether conclusions from theoretical and empirical research carried out in developed economies are valid for developing countries too, or a different set of factors influence capital structure decisions in developing countries? We are not sure whether conclusions from research on capital structure are portable across countries in general. Rajan and Zingales (1995) studied the G-7 countries while Booth et al (2001) extended this work by including some data from emerging markets. The conclusions from these studies were that there were some common features in the capital structures of firms in different countries but that further research was necessary to identify the determinants of capital structure in particular institutional settings or countries. Thus this study intends to fill this research gap.

The main purpose of this study is to identify the determinants of capital structure of Sri Lankan Manufacturing sector and Services sector companies in the light of the Static Trade off theory, Pecking Order theory and Agency Cost theory. In addition to explore sectoral disparity, if any, between manufacturing and services sector companies. Further this study intends to identify whether the decision of the companies concerning the leverage is in conformity with the theoretical expectations proclaimed in previous studies.

This study investigated the determinants of capital structure of a sample of Sri Lankan listed manufacturing and services sector companies using OLS dummy regression analysis. Three different leverage measures based on book values have been used: total debt ratio, long term debt ratio and short term debt ratio. The empirical evidences provide that there exist difference in the determinants of these three leverage measures as well as the sectoral differences existing in determining leverage decisions. In services companies, leverage decision is influenced by the Profitability, size and growth variables. In manufacturing companies leverage decision is influenced only by the Profitability variable. Particularly in Sri Lankan context, implication of pecking order theory is more relevant than static trade off and agency cost theories.

The paper is organized as follows: first section of the paper gives a brief introduction to the background of the study and the research objectives. Section 2 summarizes the related literature. Section 3 gives description of the methodology. Section 4 discusses the results from the model used and section 5 presents the conclusion.

2. LITREATURE REVIEW

Following on from the pioneering work of Modigliani and Miller (1958) on capital structure has generated strong interest among financial researchers. Thus, it has fulfillment with new elements over the years, such as taxes, bankruptcy costs, agency costs and the information asymmetry. In recent years, a number of theories have been proposed to explain the variation in debt ratios across firms. The theories suggest that firms select capital structure depending on attributes that determine the various costs and benefits associated with debt and equity financing. Thus theories suggest that the capital structure affect

company's value. Among them there are three conflicting theories such as static trade-off, pecking order, and agency cost theories of capital structure, which are briefly discussed.

The foundation to trade-off Modigliani and Miller (1958) who show that capital structure decision do not affect the value of firms when capital markets and firm's investment and financing decisions are independent. But it is invalid in practice. Modigliani and Miller (1963) recognize the 100% debt financing to maximize the value of the firm. This trade-off theory balances the tax advantages of borrowing against the costs of financial distress. Companies with safe, tangible assets and plenty of taxable income to shield ought to have high target ratios, while unprofitable companies with risky, intangible assets ought to rely primarily on equity financing. According to Titman and Wessels (1988) tangible assets end up helping companies to accumulate debts and if the investment proves a failure, the creditor will charge the guarantee offered. It also says that companies saddled with extra heavy debt - too much to pay down with a couple of years' internally generated cash should issue equity or sell off assets to raise cash to rebalance the capital structure. In addition Mason (1990) found that tax-paying companies are more likely to issue debt (Vs equity) than non taxpaying companies. This shows that taxes do affect financing choices. Contrarily a study by Fama and French (1998) covering over 2000 firms between 1965 to 1992, failed to find any evidence that interest tax shields contributed to firm value. Further, Bevan and Danbolt (2000 and 2002) find a positive relationship between tangibility and long-term debt, whereas a negative relationship is observed for short-term debt and tangibility in UK. While Um (2001) suggests that a high profit level gives rise to a higher debt capacity and accompanying tax shields. Hence, it is expected that a positive relationship should exist between profitability and financial leverage. Rather than tangibility and profitability, several studies find that the size of a firm is a good explanatory variable for its leverage ratio. Bevan and Danbolt (2002) argue that large firms tend to hold more debt, because they are regarded as being 'too big to fail' and therefore receive better access to the capital market. Also some other studies Rajan and Zingales (1995), Wiwattanakantang (1999), Booth et al (2001), Pandey (2001), Al-Sakran (2001), and Huang and Song (2002) find a significant positive relationship between leverage ratios and size in developing countries. Meanwhile Titman and Wessels (1988) report a positive correlation between the size of the firm, the total debt ratio and the long term debt ratio. On the other hand, Bevan and Danbolt (2002) report that size is found to be negatively related to short term debt and positively related to long term debt.

The literature on pecking order of financing dates back to the early 1960s. The theory states that a company's investment is financed first with internal funds, reinvested earnings primarily, then by new issues of debt and finally with new issues of equity. Donaldson (1961) found a pecking order of financing in his survey on how companies actually establish their capital structure in the US market. He also reports that firms prefer to finance with internally generated funds and debt issues. The new equity share issues play a relatively small role in financing investment projects of firms. Myers (1984) refers to this as a 'pecking

order theory' which states that firms prefer to finance new investment, first internally with retained earnings, then with debt, and finally with an issue of new equity. Consistent with the pecking order theory, work of Titman and Wessels (1988), Rajan and Zingales (1995), Antoniou et al, (2002) and Bevan and Danbolt (2002) in developed countries, Booth et al, (2001), Pandey (2001),Um (2001),Wiwattanakantang (1999), Chen (2004) and Al-Sakran (2001) in developing countries all find a negative relationship between leverage ratios and profitability. Contradicting this, Booth et al (2001) revealed that, generally a positive relationship exists between growth and debt ratios in all countries in their sample, except for South Korea and Pakistan. Pandey (2001) also argued that there is a positive relationship between growth and both long term and short term debt ratios in Malaysia. Myers (1984) argues that there is a positive relationship between tangibility and financial leverage. Consistent to his argument, empirical evidences were also reported by Titman and Wessel (1988) and Rajan and Zingales (1995) in developed countries.

Theory based on agency costs illustrates that firm's capital structure is determined by agency costs, which includes the costs for both debt and equity issue. When a company has debt, conflicts of interest arise between stockholders and bondholders. Because of this, stockholders are tempted to follow self-seeking strategies. These conflicts of interest which are overblown when financial distress is incurred impose agency costs on the company. In this context, Jensen (1986) argues that debt has to be paid back in cash. Therefore the amount of free cash flow that could be derived by the manager is reduced by debt. Thus debt serves as a mechanism to discipline the manager from encouraging in self-serving activities. e.g. perquisite consumption, empire building, etc. Booth et al (2001) find that the influence of tangibility will differ between the long term and total debt ratios as firms match the maturity of their debt to the tangibility of their assets. While Jung, Kim, and Stulz (1996) show when management pursues growth objectives, external common equity is valuable for firms with strong investment opportunities, because management and shareholder interests coincide. In contrast, for firms with weak investment opportunities, debt serves to limit the agency costs of managerial discretion as explained by Jensen (1986) and Stulz (1990), and also shown by Berger, Ofek, and Yermack (1997). Further Smith and Watts (1992) provide empirical evidence, using US data that support a negative relation between leverage and growth opportunities and Titman and Wessels (1988) also estimate a negative empirical relationship between leverage and R&D expenses. R&D is frequently treated as a proxy for growth opportunities. Consistent with these predictions, Chung (1993) as well as Rajan and Zingales (1995) find a negative relationship between growth and the level of leverage on data from developed countries.

At the outset, it is worth reviewing the previous studies on Sri Lankan companies that are related to leverage and capital structure. Samarakoon (1997) investigated the ability of market beta, book - to - market equity, leverage and earning price ratio to explain the cross sectional variation in expected returns in Sri Lanka. He found no evidence of a relationship between mean returns, size of the firm, book-to-market equity and leverage. Senerathne (1998) tested the

applicability of pecking order theory of financing in Sri Lanka. The results suggested that Sri Lankan companies follow the pecking order partially. Colombage (2005) empirically investigates the capital structure of Sri Lankan companies and finds that the financing trend of Sri Lankan firms confirms the pecking order hypothesis to a greater extent than predictions of information asymmetry and static tradeoff consideration. Champika and Gunaratne (2007) found that Sri Lankan firms demonstrated a market timing behavior in adjusting their capital structure. They also revealed that profitable firms are particularly very much reliant on internal financing.

Sri Lanka is a developing country with one stock exchange, the Colombo Stock Exchange (CSE) being the one and only one. Nearly 240 companies are listed on CSE. Like other developing economies, the area of capital structure is relatively unexplored in Sri Lanka. Limited research work exists in this area. The purpose of this study is to fill this void to some extent by providing empirical evidence from a developing country's perspective. However, this study was confined only to manufacturing and services sector companies. However these two sectors play an important role in the Sri Lankan economy. The service sector is the largest component of GDP at almost 60%, while manufacturing is the largest industrial subsector, accounting for nearly 18% of GDP.

3. RESEARCH METHODOLOGY

3.1. DATA AND SAMPLE

The data set used in the analysis is constructed by merging companies' balance sheet and income statement information obtained from the Hand Book of Listed companies - 2002 and 2007 published by CSE. For inclusion in the sample 5 years data, from 2003-2007 is used, resulting in a panel database of 63 companies. The data were averaged over the five years to smooth the leverage and selected variables. Two sets of samples are selected. The first one is from Sri Lankan Manufacturing sector companies listed on Colombo Stock Exchange covering the period of 2003-2007 and comprised 18 (50 % of total companies) of listed companies. The second one is from Services sector companies covering the same period comprised 45 (50 % of total companies) listed companies from 8 of the 20 sectors in the CSE. They are Bank finance and insurance, Health care, Hotels & travels, Information technology, Investment trust, Power & energy, Services and Telecommunication. The companies from both sectors were selected randomly.

3.2. THE VARIABLES

The variables used in this study and their measurement are largely adopted from existing literature. This will help to highlight the similarities as well as the differences in the determinants of capital structure in other countries. This study considered four key variables identified in studies by Rajan and Zingales (1995), and Bevan and Danbolt (2002). The selected independent variables are: profitability,

tangibility, size and the level of growth opportunities. While dependent variables are leverage ratios such as total debt ratio, long term debt ratio and short term debt ratio, they are defined as follows.

Leverage ratios are based on book values

- a) Total debt ratio - the ratio of total liabilities to total assets.
- b) Long term debt ratio- the ratio of long term liabilities to total assets.
- c) Short term debt ratio - the ratio of short term liabilities to total assets.

Independent variables are defined as

1. Profitability - the ratio of Earnings Before Tax (EBT) scaled by total assets.
2. Tangibility - the ratio of fixed assets to total assets.
3. Size - company size is the natural logarithm of sale.
4. Growth - the company growth rate is the percentage change of total assets.

3.3. EMPIRICAL METHODOLOGY

Ordinary Least Squares (OLS) dummy Regression model is used to identify the determinants which influence on leverage decisions of manufacturing and services companies. This model is motivated by the work of Rajan and Zingales (1995). They argue that the ordinary least square (OLS) results are very similar to those results that are obtained using the alternative techniques. Bevan and Danbolt (2002) have confirmed these findings. Bevan and Danbolt (2002) point out that capital structure studies examining the determinants of leverage based on total debt may disguise the significant differences between long term and short term debt. Therefore, in line with Bevan and Danbolt (2002) and Michaelas (1998), this study split total debt into long term and short term debts. The leverage ratios considered are: total debt to total assets, long term debt to total assets, and short term debt to total assets. This study relates average of each leverage ratio of i th companies' for a time period of five year period $t-1$ to $t-5$ with the average of the each of the independent variables calculated over a five year period $t-1$ to $t-5$, while i refer to the individual companies. This model eliminates the problem of heterogeneity of data.

Least Squares Dummy Regression Model

$$LEV_i = \alpha + \beta_1 X_{1n} + \beta_2 D_{2i} + \beta_3 X_{3n} + \varepsilon_i \quad (1)$$

Where:

LEV_i denotes average of each leverage ratio of company i and it is computed as the ratio of total debt to total assets, long-term debt to total assets, and short-term debt to total assets, in alternative estimations;

X_{in} denotes the selected variables of i^{th} companies' average of n^{th} factor variable as following ($n = 0, 1, 2,$ and 3)

$n=0$ denotes profitability is estimated by the ratio of profit before tax to the book value of total assets;

$n=1$ denotes tangibility is measured by the ratio of fixed assets to total assets,

$n=2$ denotes size is measured by the natural logarithm of total sales and

$n=3$ denotes growth is measured by the percentage change in the value of total assets,

β_1 denotes the coefficient of manufacturing sector companies;

β_2 is the coefficient of dummy variable;

β_3 denotes the coefficient of services sector companies;

D_i denotes a dummy variable and $D_i = 1$, if i^{th} company is in a service sector; $D_i = 0$, if i^{th} company is in a manufacturing sector;

α is the intercept, and

ε_i is the random error term.

4. ANALYSIS AND DISCUSSION OF RESULTS

4.1. DESDRIPTIVE STATISTICS

Table 01 summarizes the statistics for the selected variables and leverage measures for the whole sample of Sri Lankan companies, and the two sub-samples; Manufacturing and Services sector companies.

From table 01, it can be seen that Sri Lankan companies have a low rate of profitability (4.9 percent). The growth rate on average is 23.85 percent and the services companies tend to have a higher average growth rate than the manufacturing ones. Due to that the services companies have, on an average, higher total assets than manufacturing companies. Based on size, as expected, the manufacturing companies are bigger than the services companies. The ratio of total debt on average is 50.81 percent of total book value of assets, while manufacturing companies (55.2 percent) are having higher average total debt ratio than the services (49.06 percent) ones. It is also close to the average total book - debt level of 51% in developing countries (Booth et al., 2001). Services companies tend to have a higher average long term debt (33.01 percent) than the short term debt (16.89 percent), but it is the opposite in manufacturing companies (long term debt- 20.6 percent, short term debt - 39.2 percent). This implies that manufacturing companies prefer short term loans rather than long term ones. The substantially low amount of long term debt reflects the fact that the listed manufacturing companies are mainly financed by share capital rather than debt. Bank loans provide short term financing for working capital; equity is the main source of finance for capital investment. Contrarily, in the services companies higher level of tangible assets requires higher level of long term debts than short term loans.

Table 01: Descriptive statistics of the selected variables

	Profitability	Tangibility	Size	Growth	Total debt ratio	Long term debt ratio	Short term debt ratio
Whole Sample							
Mean	0.0497	0.6465	8.8944	0.2385	0.5081	0.2941	0.2327
Median	0.0467	0.6723	9.0127	0.1792	0.4517	0.1752	0.1943
Maximum	0.2263	0.9662	10.488	2.8256	1.2445	0.8863	0.6840
Minimum	-0.3246	0.1027	7.026	-0.0818	0.0106	0.0010	-0.1595
Std. Dev.	0.0819	0.2382	0.7812	0.3816	0.2922	0.2840	0.1763
Services firms							
Mean	0.0396	0.7123	8.775	0.2697	0.4906	0.3301	0.1689
Median	0.0345	0.8011	8.719	0.1840	0.3823	0.1752	0.1602
Maximum	0.2263	0.9662	10.488	2.8256	1.2445	0.8863	0.5096
Minimum	-0.3246	0.1027	7.026	-0.0818	0.0106	0.00102	-0.1595
Std. Dev.	0.0891	0.2348	0.8650	0.4431	0.3165	0.3138	0.1398
Manufacturing firms							
Mean	0.0751	0.4820	9.1925	0.1606	0.5520	0.2061	0.3920
Median	0.0780	0.4915	9.201	0.1504	0.5203	0.1803	0.3782
Maximum	0.1611	0.7868	9.7962	0.4312	1.0206	0.7125	0.6840
Minimum	-0.0278	0.2246	8.3983	-0.0509	0.1888	0.0302	0.1653
Std. Dev.	0.0542	0.1552	0.3949	0.1187	0.1584	0.1697	0.1584

Table 02 presents a correlation matrix of the leverage and selected variables of whole sample. The results show that growth and size are positively related to profitability, while tangibility has a negative relationship with profitability. This implies that larger companies and growing companies tend to have higher profitability, whereas, profitable companies tend to have less tangible assets. Despite the fact that this correlation matrix ignores joint effects of more than one variable on leverage, the tangibility and growth variables have a positive correlation with long term debt, and a negative correlation with short term debt. Profitability has a negative correlation with short term debt, long term debt and total debt ratios. Contrarily size has a positive correlation with short term debt, long term debt and total debt ratios. This implies that Growing companies and companies with high levels of tangible assets tend to use long term debt rather than short term debt. Profitable companies are less likely to use short term, long term debt and tend to use less debt overall.

Table 02: Correlation matrix of whole sample

Variables	Profitability	Tangibility	Size	Growth	Total debt ratio	Long term debt ratio
Tangibility	-0.223					
Size	0.205	-0.117				
Growth	0.065	-0.063	-0.053			
Total debt ratio	-0.269	-0.017	0.484	0.138		
Long term debt ratio	-0.207	0.188	0.460	0.137	0.827	
Short term debt ratio	-0.112	-0.34	0.141	-0.021	0.416	-0.095

4.2. EMPIRICAL RESULTS

To find the determinants of capital structure, the relationships between the levels of debt and four selected variables representing profitability, tangibility, size and growth, are examined using ordinary least square dummy regression. Results are shown in table 03 and 04, the independent variable provides considerable level explanatory power as indicated by adjusted R^2 's values of 0.45, 0.37 and 0.44 for total debt, long term debt and short term debt in manufacturing companies, while adjusted R^2 's values of 0.44, 0.40 and 0.10 for total debt, long term debt and short term debt in services companies. This might be considered reasonably good fit in both sectors. F statistics shows that overall models are significant at one percent in both sectors except short term debt in services companies.

Table 03: Results of OLS analysis over different measures of leverage

Variables	Total debt ratio	Long term debt ratio	Short term debt ratio
<i>Intercept</i>	1.550 (1.24)	0.609 (0.47)	0.6399 (0.84)
<i>Profitability</i>	-2.706** (-2.21)	-0.474 (-0.37)	-2.3926*** (-3.22)
<i>Tangibility</i>	0.1295 (0.33)	0.3041 (0.76)	-0.2148 (-0.91)
<i>Size</i>	-0.0871 (-0.64)	-0.0475 (-0.34)	0.00704 (0.09)
<i>Growth</i>	-0.3511* (-0.71)	-0.4807 (-0.94)	-0.1825 (-0.61)
<i>D</i>	-3.058** (-2.35)	-2.416* (-0.078)	-0.4607 (-0.58)
<i>D*Profitability</i>	1.509 (1.18)	-0.417 (-0.31)	2.0704*** (2.66)
<i>D*Tangibility</i>	-0.1906 (-0.46)	-0.1935 (-0.45)	-0.0826 (-0.33)
<i>D*Size</i>	0.3200** (2.26)	0.2810* (1.92)	-0.0028 (-0.03)
<i>D*Growth</i>	0.5213 (1.05)	0.6186 (1.2)	0.2208 (0.73)
<i>Adj R²</i>	0.449	0.374	0.438
<i>F</i>	6.61***	5.11***	6.38***
<i>Obs</i>	63	63	63

t-statistics in parentheses are for coefficient and P values for diagnostic test.

* Significant at 10% level.

** Significant at 5% level.

*** Significant at 1% level.

The table 03 reveals that the interaction coefficients indicate whether there is a significant difference between the gradients of the slopes for the manufacturing and services companies. To determine whether the

slopes for the services firms are significantly different from zero, the implied coefficients for the selected variables for services companies given the regression output in Table 03 are shown in Table 04.

Table 04: Results of OLS analysis over different measures of leverage of services sector

Variables	Total debt ratio	Long term debt ratio	Short term debt ratio
<i>Intercept</i>	-1.5081*** (-3.91)	-1.8068*** (-4.57)	0.1792 (0.79)
<i>Profitability</i>	-1.1971*** (-2.92)	-0.8909** (-2.12)	-0.3222 (-1.34)
<i>Tangibility</i>	-0.0611 (-0.40)	0.1106 (0.70)	-0.1322 (-1.46)
<i>Size</i>	0.23289*** (5.55)	0.23347*** (5.43)	0.00984 (0.40)
<i>Growth</i>	0.17025** (2.08)	0.1379 (1.65)	0.03827 (0.80)
<i>Adj R²</i>	0.437	0.40	0.10
F	9.55***	8.34***	1.11
Obs	45	45	45

t-statistics in parentheses are for coefficient and P values for diagnostic test.

* Significant at 10% level.

** Significant at 5% level.

*** Significant at 1% level.

To aid identification of the pertaining capital structure theories, the tables 05 and 06 show the results of observed signs of OLS regression coefficients for four independent variables in Sri Lankan manufacturing and services sector companies are given below.

Table 05: Expected and observed signs of the coefficients for manufacturing sector

Proxy	Predicted signs of theories			Observed signs of our results		
	Static-trade off	Pecking order	Agency cost	Total debt ratio	Long term debt ratio	Short term debt ratio
Profitability	+	-	?	-**	-	-***
Tangibility	+	+	+ (Debt cost) - (Equity cost)	+	+	-
Size	+	?	+	-	-	+
Growth	-	+	-	-	-	-

A positive sign "+" indicates that the theory suggests a positive relationship between the variable and the measure of leverage, whereas a negative sign "-" indicates that the theory suggests a negative relationship between the variable and the measure of leverage. "?" means that there is no clear prediction.

Table 06: Expected and observed signs of the coefficients for services sector

Proxy	Predicted signs of theories			Observed signs of our results		
	Static-trade off	Pecking order	Agency cost	Total debt ratio	Long term debt ratio	Short term debt ratio
Profitability	+	-	?	-***	-**	-
Tangibility	+	+	+ (Debt cost) - (Equity cost)	-	+	-
Size	+	?	+	+***	+***	+
Growth	-	+	-	+**	+	+

A positive sign “+” indicates that the theory suggests a positive relationship between the variable and the measure of leverage, whereas a negative sign “-” indicates that the theory suggests a negative relationship between the variable and the measure of leverage. “?” means that there is no clear prediction.

4.2.1. PROFITABILITY

The most important variable is beyond doubt the profitability variable which is statistically significant considering the p-values and t-values 2.21 and 3.22 with total and short term debt at 5% and 1 % respectively in manufacturing companies as shown in table 3. It is also significantly associated with total and long term debt at 1% and 5% respectively in services companies as shown in p-values in table 04. Therefore profitability is an important determinant of capital structure in Sri Lankan manufacturing and services companies. Consequently it can be claimed that profitability does have a significant role in making debt ratios and consequently determine capital structure of Sri Lankan companies. This result is consistent with the result of Titman and Wessels (1988), Harris and Raviv (1991) and Rajan and Zingales (1995) also provide evidence of a reliable negative relationship between leverage and profitability in the US, Japan and Canada.

Table 05 and 06 show the result of negative association of profitability with all three types of debt is consistent with implication of the pecking order theory. This means that Sri Lankan companies follow a preferential order of financing sources. This means they use internal funds before seeking debts. It also supports the existence of significant information asymmetries. Consistent with this theory, Toy et al., (1974), Kester (1986), Titman and Wessels(1988), Bennett and Donnelly (1993), Rajan and Zingales (1995), and Bevan and Danbolt (2002) all find leverage to be negatively related to the level of profitability.

4.2.2. TANGIBILITY

Much research, examining the correlation between leverage and tangibility in developed as well as developing countries, has proved that a positive relationship exists because tangible assets are easy to collateralise for debt. Our results show that the tangibility has a positive coefficient with total and long term debt in manufacturing companies and with long term debt at services companies. In turn, this is negatively associated with short term debt in both sector companies. P-values suggested that this variable lose its statistical significant in both sectors with all types of debt. Thus this variable is not related to leverage decision in any significant way. This may be due to the fact that, in practice less weight is given to the collateral, in lending decision.

Casual empiricism suggests that companies tend to obtain unsecured loans from domestic and foreign sources. Hence, tangibility should not necessarily be a significant determinant of leverage ratio. This is consistent with the findings of Shah and Hijazi (2004) in Pakistan. Manufacturing companies' tangibility is positively associated with total and long term debt and also it has a positive coefficient with long term debt in services companies depicted in tables 05 and 06. This result is consistent with the implication of static tradeoff, pecking order and agency cost theories. However it does not have any significant relationship in determining capital structure decision in Sri Lankan companies.

The fact that tangibility has a strong influence on long term debt decisions in the developed countries being very much in vogue, has been highlighted in the various capital structure theories. This study emphasizing the insignificance in any one of the three types of debts in either sector, clearly illustrates the presents some other factor (s) influencing decisions in debts. While further research in this area is necessary, it is felt that these could possibly be the stature of proprietor or the head and/ or culture of the companies involved.

4.2.3. SIZE

According to table 04, size is a significant variable of capital structure in services companies. It is statistically significant with total and long term debt at 1% as shown p-values and t-values 5.55 and 5.43 respectively. Clearly large firms seem to be having high leverage than small firms. Thus it could be confirmed that size also plays a vital role in taking capital structure decisions of Services sector companies in Sri Lanka. In contrast table 03 shows this is a statistically insignificant variable in all three types of leverage ratios, in manufacturing companies.

Thus size is found to have positive impact over all leverage ratios at services companies and short term debt of manufacturing companies. This positive relationship is consistent with implication of static tradeoff and agency cost theories, while this is verified by most studies with a few exceptions. For example Rajan and Zingales (1995) found size to be positively associated with leverage in G-7 countries except Germany and this exception is hard to explain from the view of institutional differences. Fama and Jensen (1983) argue that larger firms provide more information to outside investors than smaller firms. Benefiting from the low information asymmetry, larger firms are expected to have easier access to debt market and borrow at a lower cost.

4.2.4. GROWTH

Another factor, which is supposed to affect capital structure, is growth potential. A positive relationship between growth opportunities and total, long and short term debt is found in services sector companies in Sri Lanka, which conforms to the same relationship found in the developed countries except the United States, Wald (1999). However table 04 indicates that t-value of 2.08 of total debt alone is statistically significant at 5 % level in services companies. On the other hand, Growth variable

is insignificant and is negatively related to all leverage ratios in manufacturing companies. As expected, these negative coefficients show that growing firms do not use debt financing. One reason may be that most of the listed companies in manufacturing possess more tangible assets and less intangible assets such as good will, R&D, and advertising, and thus have limited growth opportunities. This is a reflection of the generally low technology level of Sri Lankan companies. Manufacturing companies' results are in conformity with the result of Titman and Wessels (1988); Barclay, et al. (1995) and Rajan and Zingales (1995). Therefore, it does not have any significant impact in manufacturing companies, while total debt ratio of the services companies is statistically significant with growth variable.

Growth is negatively associated with all types of leverage ratios in manufacturing companies. But this result is quite opposite in all types of leverage ratios for services companies. Manufacturing companies' result is consistent with the static trade off and agency cost theory and services companies' positive association follows pecking order theory. Thus services companies with high growth rate borrow more than companies with low growth rate.

Further, the results imply that other than selected 'firm - specific' variables could influence capital structure decisions in Sri Lanka. Significant institutional differences such as the legal system governing companies' operation and banking and securities markets, ownership concentration and the corporate governance structure of the listed firms, the agency problems inheriting from public ownership, and the financial constraints in the banking sector are all factors influencing the roles of firm-specific factors on companies' leverage decision.

5. CONCLUSIONS

The findings of this study contribute towards a better understanding of capital structure decisions in the Sri Lankan context. This study analyses the determinants of the capital structure of 63 Sri Lankan manufacturing and services companies from 2003 to 2007, and the extent to which the influence of these determinants on leverage decision. The results of our OLS regression find that profitability was confirmed to be a relevant determinant for Sri Lankan manufacturing and services sector companies. More profitable companies would tend to have fewer debts, since they use the retained earnings rather than debts. Further, size and growth variables were also determining the leverage decision of services companies. Hence larger and growing companies tend to use more debts. Tangibility was confirmed not to have any significant effect in capital structure decisions for Sri Lankan services companies.

Tangibility, Size and Growth variables were confirmed not to have material effect in capital structure decisions for Sri Lankan manufacturing companies.

There was a strong evidence to support the pecking order theory by manufacturing sector companies based on the relevant determinant of profitability variable, whereas services sector companies' determinants of profitability and growth variables were again strongly supported to

the implication of the pecking order theory. Nevertheless, both static trade off and agency cost theory cannot be rejected due to their correct prediction of the sign of size variable of services companies. Therefore it could be concluded that implication of pecking order theory is more relevant in Sri Lankan context.

Finally the results of this empirical study suggest that some of the insights from modern finance theory are portable to Sri Lanka in that certain firm-specific factors that are relevant for explaining capital structure in the Western countries are also relevant in Sri Lanka. This is true, despite profound institutional differences that exist between Sri Lanka and the Western countries. Knowing these factors could help predict the financial structure of a firm. The Pecking order model along with static trade off and Agency cost theory seems to provide partial explanations.

This paper has laid some groundwork to explore the determinants of capital structure of Sri Lankan manufacturing and services sector listed companies, upon which a more detailed evaluation could be based. Further work is required to develop new hypotheses for the capital structure decisions of Sri Lankan companies and to design new variables to reflect the institutional influence. A larger, comprehensive, and detailed database is also required for a further detailed capital structure study.

The following are the major implications related to the debt financing behavior of the companies in Sri Lankan context.

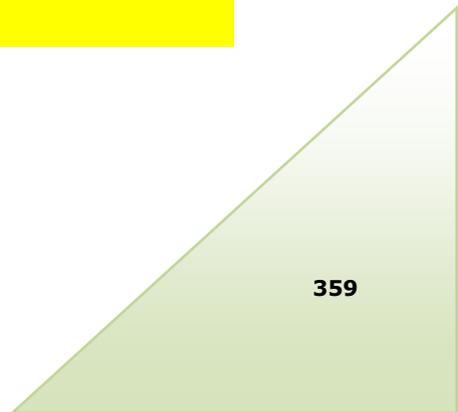
- The average debt ratio of Sri Lankan companies is around 50%.
- In services companies, leverage decision is influenced only by the Profitability, size and growth variables.
- In manufacturing companies leverage decision is influenced only by the Profitability variable.
- Strangely tangibility which in theory should have great influence on decision pertaining to leverage is found to be insignificant as arrived at in this study.
- Factors other than selected variables could have an influence on leverage decision.
- There are sectoral differences existing in determining leverage decisions.
- In Sri Lankan context, implication of pecking order theory is more relevant than static trade off and agency cost hypothesis.

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Comparative Analysis of Reporting Bases of Czech Republic, Macedonia and Albania with IFRS: Are They Really So Different?

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ABSTRACT

The European Union (EU) Regulation 1606/2002 requires all listed companies of the member states to prepare consolidated financial statements based on the International Financial Reporting Standards (IFRS) for accounting periods beginning on or after 1 January 2005. The adoption of IFRS is supported in many countries inside and outside the European Union because it may improve the quality and comparability of financial reporting. In addition to the use of IFRS by listed companies and in some countries also by unlisted companies, many countries have developed their own national accounting standards based on the international ones. Although the national standards are based on IFRS, they are not identical. The Czech Republic, Macedonia and Albania are transitional economies based in "Central and Eastern Europe". Czech Republic joined EU in May 2004, whereas Macedonia and Albania are still the candidate countries. The purpose of the paper is to compare national accounting standards of the Czech Republic, Macedonia and Albania with IFRS, look at approaches of these countries to aspects of financial reporting, and analyze differences and similarities using Jaccard's association coefficients as a general tool.

1 Introduction and Literature Review

The globalisation and the expansion of markets as well as the general progress in the technologies available have brought new problems to the compilation of financial reports and to the ascertainment of trading income of supranational corporations and groups in accordance with statutory regulations of countries involved.

Without common accounting standards, there could be 27 different national methods of accounting in addition to the use of IFRS and US GAAP, which are permitted by some EU countries (Whittington, 2005). Brown and Tarca warn that "the future of the IASB is tied to the successful introduction of IFRS in Europe" (Brown and Tarca, 2005). The EU motivates the regulation by referring to the enhanced international comparability and transparency of financial statements and improved access to the international capital markets resulting from IFRS usage (Cuijpers and Buijink, 2005). In the year 2002, the European Parliament and the Council of the European Union issued Regulation 1606/2002 whereby it stipulated certain duties on the part of companies listed on

European stock exchanges to compile their consolidated accounting statements in accordance with IFRS. Therefore, beginning from 2005, a large number of listed enterprises, exhibiting significant heterogeneity in size, capital structure, ownership structure and accounting sophistication, started to apply international standards for the first time. The demand for detailed application guidance will increase substantially, as will the demand for uniform financial reporting enforcement throughout the European Union. Schipper states "if the IASB declines to provide detailed implementation guidance for IFRS, I predict that preparers and auditors will turn elsewhere, perhaps to US GAAP or perhaps to jurisdiction-specific European GAAP, for that guidance" (Schipper, 2005).

In addition to the use of IFRS by listed companies, many countries adopt international standards for unlisted companies or model their domestic standards on the basis of international standards. The Australian government had decided to adopt international standards for the statutory accounts of all domestic companies from 2005, and New Zealand has indicated the year 2007. The 2003 survey by Deloitte and Touche (2007) suggested that more than 90 countries would either require or permit IFRS for listed companies by 2005, and according to the latest Deloitte survey now there are over 100 such countries. This provides an interesting example for those who argue that accounting standards should be left to competition in the marketplace (e.g. Watts and Zimmerman, 1986).

The requirements for group listed enterprises to prepare IFRS reports from 2005 were established in most transitional economies, but it is still unclear to what extent other enterprises will prepare IFRS financial statements. Concerns about the lack of suitably trained accountants and auditors and the lack of efficient markets to ensure reliable fair values for the IFRS financial statements, have already been expressed (Eccher and Healy, 2007; Sucher and Alexander, 2002). This may cast doubt on whether the financial statements issued under IFRS will be reliable. Indications are that in most of the transitional economies of Eastern and Central Europe, other non-listed enterprises will not have to prepare financial statements according to IFRS (Sucher et al., 2005).

From the year 2005, the public listed companies in the Czech Republic should report under the IFRS framework, while the non-listed companies still report under the Czech accounting principles. The Czech Accounting Act was adopted in 1992 and since then has been changed 15 times. Unfortunately, these changes do not comply with the necessity of the harmonization of the Czech accounting with IFRS. Surprisingly, the definition of the balance sheet items is still missing in Czech GAAP.

Macedonia gained its independence from Yugoslavia in 1991. Since the Stabilization and Association Agreement in April 2001, the economic orientation of Macedonia has moved increasingly toward Western Europe. Consequently of economic integration, accounting harmonization has become even more important after the European Union (EU) granted Macedonia candidate status on December 17, 2005. According to Company Law (2004, Article 469), each commercial entity shall be obliged to keep accounting records and submit annual accounts in a manner determined by this law, and the accounting regulations.

Each large and medium size commercial entity, commercial entities specified by a law, as well as commercial entities performing banking activities, insurance activities, commercial entities listed on the Stock Exchange and commercial entities, the financial statements of which are included in the consolidated financial statements of the above mentioned commercial entities, shall be obliged to prepare and submit financial statements in accordance with the adopted International Accounting Standards, published in the "Official Gazette of the Republic of Macedonia". Accounting regulation is driven by the Ministry of Finance, which also regulates and collects taxes. On the other hand, implementation of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) is not an enclosed process, but it is the standard-setting process which takes into account the needs of all accounting information users. According to Macedonian Company Law, regulation in line of preparing and presentation of financial statements is more a formal than essential a guide. It doesn't mention others criteria like International Accounting Standard 1 for fairly presentation, going concern, accrual basis, consistency of presentation, materiality and aggregation, comparative information, etc. Those are fulfilled in Macedonian Law on Accountancy. But, oriented according two laws, i.e. Company Law and Law on Accountancy can be an obstacle for companies in line of preparing and presentation of financial statements. The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation (IAS 1.13).

IAS 1 requires that an entity whose financial statements comply with IFRSs make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs (including Interpretations) (IAS 1.14). Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material (IAS 1.16). IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure (IAS 1.17-18).

An entity preparing IFRS financial statements is presumed to be a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case IAS 1 requires a series of disclosures (IAS 1.23). IAS 1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual basis of accounting

(IAS 1.25).

The presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new IFRS (IAS 1.27). Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial (IAS 1.29).

Assets and liabilities, and income and expenses, may not be offset unless required or permitted by a Standard or an Interpretation (IAS 1.32). IAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise (IAS 1.36). If comparative amounts are changed or reclassified, various disclosures are required (IAS 1.38).

2 Current Reporting in Czech, Macedonia and Albania



source: www.wikipedia.org (map of Europe)

2.1 Czech Reporting

From the year 2005, IFRS were given as a legal framework for the reporting of listed companies in all E.U. countries. The "target user" of the financial statements in the Czech Republic is still the tax authority, not the investor or owner. Moreover, unlike international standards, the Czech accounting regulations lack a glossary of definitions for basic elements of financial statements, which is why we shall use the definitions applied in IFRS standards, namely in the Framework. Reliable measurement is expected from all entries involved.

Concerning the initial recognition under Czech laws, the Accounting Act (Section 24) identifies the following valuation alternatives:

2. historical costs, i.e. the cost of acquisition of the assets concerned, including the costs related to the acquisition itself;
3. replacement/reproduction cost, i.e. the cost for which the assets would be obtained at the time of the accounting statement;
4. production costs, which include all direct costs expended on the manufacturing or other activity and that part of indirect costs, which is related to the manufacturing or other activity involved;
5. nominal value, i.e. the face value.

In the Czech Republic, items are usually measured at historical costs, while donated or gratuitously procured assets are measured by replacement costs, which are the approximate equivalent of the reproduction cost as defined by IFRS. Under certain circumstances, the realizable value and the fair value also may be used as the measurement bases for financial accounting. On the other hand, the Czech regulations virtually ignore measurement methods based on present value (Strouhal et al., 2009), which are required for measurement of long-term receivables, long-term payables and financial assets held to maturity (under IFRS).

Under Section 18 of the Accounting Act, the financial statements comprise: balance sheet, profit and loss statement, and notes. At the same time, Section 18 also contains the following unfortunate sentence "the financial statements may also include a cash-flow statement and the statement of changes in equity". This means that under Czech laws, the cash-flow statement is not an obligatory component of the financial statements, not even for the accounting entities, which are liable to statutory audit [Strouhal]. On the other hand, international standards stipulate that the above statements be an integral part of the financial statements. The subsequent text deals mainly with the balance sheet and the P/L Statement.

2.1.1 Financial Statements

The Czech regulations do not require the separate reporting of discontinued operations, while IFRS stipulate that discontinued operations be disclosed and presented separately in accordance with IFRS 5. In particular, IFRS 5 stipulates that "the sum of the post-tax profit or loss of the discontinued operation and the post-tax gain or loss recognized on the measurement to fair value less cost to sell or fair value adjustments on the disposal of the assets (or disposal group) should be presented as a single amount on the face of the income statement. Detailed disclosure of revenue, expenses, pre-tax profit or loss, and related income taxes is required either in the notes or on the face of the income statement in a section distinct from continuing operations".

Pursuant to the Fourth Directive of the E.U., accounting entities should compile the profit and loss statement vertically, allowing for the presentation of expenses either according to their nature or function. However, if the profit and loss statement is arranged with respect to the function of entries involved, an accounting entity must also include a schedule disclosing the operating costs classified with respect to their

nature.

Under IAS 1, an entity should also report the earnings per share ratio (EPS). Unlike US GAAP, international standards do not require that costs be classified as to their function in the profit and loss statement. Instead, they only demand that accounting entities submit an analysis of costs classified as to their nature or function, whichever classification provides more reliable or more relevant information. However, the function-base classification allows for an amount of certain discretion with respect to the assignment of costs to individual functions.

There exist two basic differences between the profit and loss statement compiled in accordance with Czech rules and in compliance with IFRS: IFRS have revoked the obligation to report extraordinary expenses and extraordinary revenues – as of 1 January 2005, accounting entities disclose extraordinary expenses and revenues under their other expenses and revenues; the Czech regulations have included the entries for re-allocation of expenses to inventory and fixed assets and change in inventory of finished goods and work in progress among the revenue entries. However, since IFRS do not recognize the above entries as revenues, they have been included among adjustments to operating expenses.

Firms with international stock exchange listings face additional capital market pressures [Meek et al.] and stock exchange requirements (Cooke, 1992) that may lead them to increase their level of disclosure. Investors demand information about the domestic operating environment and domestic accounting regulations of foreign listed firms (Nobes and Parker). Many stock exchanges around the world allow foreign registrants to prepare their financial statements according to IFRS or US GAAP. Prior studies show that the level of disclosure (Meek et al, 1995.) and the probability of using non-local GAAP (Ashbaugh, 2001; Dumontier and Raffounier, 1998; El-Gazzar et al., 1999; Leuz, 2003; Leuz and Verrecchia, 2000; Murphy, 1999) are positively associated with the number of foreign stock exchange listings of a firm. The impact on financial reporting of cultural differences has been well documented (Radebaugh and Grey, 2002). There may be more disclosure by UK and US companies that have a culture of disclosure of information than by companies that have not traditionally aimed to produce especially transparent financial statements (e.g. companies from transitional economies such as the Czech Republic).

2.1.2 Reporting of Balance Sheet Items under Czech Principles

Intangible fixed assets are intangible assets, which the accounting entity intends to keep for more than one accounting period (the Income Tax Act also specifies that the input price of intangible fixed assets must exceed the sum of CZK 60 000).

The value of intangible fixed assets is measured by historical cost (acquisition price) for assets purchased, by production costs for internally generated assets and by replacement price for assets obtained gratuitously. Intangible fixed assets are subject to amortization; the amortization period is stipulated by the Income Tax Act. The intangible fixed assets must be accounted for in compliance with the prudence principle as of the balance day, meaning that the accounting entity

should disclose either the net book value of the intangible fixed assets, or the lower present market price.

Unlike under the Czech regulations, under IFRS the incorporate expenses as well as research and development (R&D) should be accounted for under expenses. Under certain circumstances, R&D may also be capitalized in the balance sheet. Goodwill pursuant to IFRS 3 should be disclosed only in the event that the goodwill was generated by acquisition. Advance payments may be offset against debts from the same title.

Tangible fixed assets include tangible assets, which the accounting entity intends to keep for more than one accounting period (the Income Tax Act also specifies that the input price of the tangible fixed assets must exceed CZK 40 000).

The value of the tangible fixed assets is measured by historical costs (acquisition price) for assets purchased, by production costs for processed production and by replacement price for assets obtained gratuitously. Tangible fixed assets are subject to depreciation; the accounting books should show the so-called book depreciation.

The tangible fixed assets must be accounted for in compliance with the prudence principle as of the balance day, meaning that the accounting entity should disclose either the net book value or the lower present market price of the tangible fixed assets concerned.

Measurement at fair values is preferred by the international companies in the Czech Republic. We think that there is a good information background for the calculation of the fair value of property, plant and equipment (PPE) or investment property. On the other hand, the Czech Ministry of Finance prefers the prudence principle and also, for the Tax Authorities, it is much easier to find out the historical costs rather than to calculate the fair value.

Financial leases are treated totally differently under Czech GAAP. The "form over substance" principle is fully applied, as it is the leasing company, which reports the leased assets, not the lessee! We think that this is the main problem of Czech GAAP nowadays and has great consequences for financial decisions. Also, it should be stated here the unwillingness of the Czech Ministry of Finance to solve the problem with financial leases as under IFRS, where the traditional principle "substance over form" is used.

Inventories are current assets consumed by an entity during one year or within one operating cycle for generating revenues. Usually, we distinguish between inventory purchased and processed production.

At the time of acquisition, the value of inventories is measured by the historical costs (acquisition price for purchased inventories), replacement price (for inventories obtained gratuitously) and production costs (for processed production).

For the measurement of the value of inventory decrement, the same cost formula should be used for all inventories with similar characteristics as to their nature and use to the enterprise. For groups of inventories that have different characteristics, different cost formulas may be justified, including FIFO, the weighted average cost formula, the fixed inventory price with independent disclosure of variations or the actual acquisition price.

Accounting entities are entitled to choose from the continuous inventory system (method A) and the periodic inventory system (method B) for inventory records. In the continuous inventory system, accounting entities record inventories via account groups Materials, Processed Production and Goods and allocate inventory decrement to costs (Raw Materials, Resale of Raw Materials, Consumables and Purchased Finished Goods) or to income adjustments (group Change in Inventory (Stocks)). In the periodic inventory system, accounting entities record the purchased inventories in the relevant costs accounts and during the accounting period do not even use balance-sheet entries such as Inventory of Materials and Consumables or Inventory Purchased for Resale – In Storage. Instead, as of the balance day, the accounting entity transfers the initial status of the balance-sheet entries into costs and based on the stock-taking results transfers from the costs the final status of purchased inventories into the balance sheet.

Inventories must be accounted for in compliance with the prudence principle as of the balance day, meaning that the accounting entity must record the inventories with their book value or with their lower present market value.

The short-term and long-term **receivables** constitute a part of current assets, while short-term and long-term **payables** are included among liabilities.

Both receivables and payables should be measured by their nominal value, unless obtained in exchange for consideration, in which case they should be measured by their acquisition price. The impossibility to measure the long-term receivables and long-term payables at their present value (what is also possible e.g. in Slovakia) is quite surprising. Accounting entities must convert receivables and payables in foreign currencies as of the moment of their measurement to Czech crowns in accordance with the current exchange rate of the Czech National Bank or a fixed exchange rate. As of the balance date, the accounting entities must also convert the sum of pending receivables and payables to Czech crowns in accordance with the current exchange rate of the Czech National Bank. Foreign currency exchange losses and gains should be recognized in the income statement.

The deferred tax assets and liabilities arise from the differences between the accounting and taxation concepts of selected accounting entries. The accounting for the deferred taxes is based on the assumption that the accounting entity will apply the deferred tax in a later period than the due tax. The recognition and the accounting for the deferred tax are mandatory for entities, which form the consolidation units (i.e. enterprises within a group) and the accounting entities, which are obliged to compile the final accounts in their full extent. Other accounting entities may account for the deferred tax at their own discretion. The accounting for the deferred tax does not affect the tax liability. At the same time, it affects the sum of disposable profit, i.e. profit intended for allocation. The calculation of the deferred tax should be based on the balance-sheet approach. The deferred tax should be recognized for all temporary differences arising from the different accounting and tax views of entries included among assets and liabilities. It is also necessary to account for differences between the tax

and tax residual price of the deductible tangible and intangible fixed assets as well as for other differences such as the reserves created beyond the scope of statutory duty, recognition of adjustments to inventories or receivables etc.

Credits and financial assistance should be measured at their nominal value. Short-term **financial assets** are included among the current assets of an enterprise. We distinguish between cash in hand, cash at bank and short-term securities. Cash items are measured at their nominal value, while short-term securities are measured by the historical costs (acquisition price). Short-term securities are measured at fair values, however it should be stated that it is quite difficult to measure the fair values of shares because of not very transparent stock exchange in the Czech Republic (Prague Stock Exchange).

The Accounting Act stipulates that only the genuine profits should be accounted for in the balance sheet, and that the accounting entity should take into consideration all predictable risks and possible losses affecting its assets and liabilities and known to the accounting entity at the time of balance sheet compilation. Also, it should include all devaluations regardless of the fact whether the accounting entity showed profit or loss in the accounting period. The accounting entity is entitled to use **provisions**, adjustment entries and write-offs for that purpose. Provisions are aimed to cover future expenses or liabilities, whose purpose is known and which are expected to occur, but whose timing or amount is uncertain. However, provisions may not be used to adjust the value of assets.

Provisions may be used only for the purpose for which they have been originally recognized. Logically, a provision may only be used to the maximum amount in which it was created; and a provision may not have a debit balance. The balance of reserves at the end of the accounting period should be transferred to the subsequent period. Accounting entities are obliged to review provisions entered in the books at the end of the accounting period, and assess their tenability and amount. If it is discovered that the reason for which the provision has been created has lapsed, the provision should be dissolved in its full extent. If it is discovered that the provision is for a different sum than it is due, it should be adjusted. In the balance sheet, provisions should be accounted for under liabilities.

The Accounting Act defines the following types of reserves: provisions for risks and losses, provisions for income tax, provisions for pensions and similar obligations, provision for restructuring, technical provisions or other provisions pursuant to special legal regulations (statutory provisions).

The Provision Act stipulates three types of provisions for enterprises: provision for repairs of tangible assets, provision for cultivation of crops, other provisions (for the removal of mud from a pond, for the redevelopment of plots affected by mining, for the settlement of mine damage or provisions stipulated by special laws as costs required to achieve, ensure or maintain revenues).

2.2 Macedonian Reporting

According to Law on Accountancy **intangible** investments shall include:

initial investments, goodwill, investments in research and development, patents, licenses, concessions and other material right, as well as the investments in procuring intangible investments.

Tangible investments shall include: natural resources (land and forests), and the means of work (buildings, equipment, multi-year plantations, basic flock and other means of work), as well as investments in procuring natural resources and means of work.

When assessing intangible and tangible investments in the balance sheet shall be entered the amount of the unwritten-off value of the investments, as well as the amounts of the acquisition and written-off value. Intangible and tangible investments shall be systematically written off during the business year to the charge of the total income, except in the case of the users of the Budget and/or the Funds, if proceeds from the Budget and/or the Funds have not been raised as depreciation by applying the base of the annual depreciation rates resulting from the assessed duration and utilization of the proceeds and the expected income from such utilization in line with the Entity's chosen accounting policy. Intangible and tangible investments shall be written off as extraordinary expenses, except in the case of users of the Budget and/or the Funds.

Depreciation rates shall be determined independently by the Entity, provided that the annual depreciation rates determined by the nomenclature of depreciation funds. The Government of the Republic of Macedonia, by previously provided Macedonian Chamber of Commerce opinion, regulates the nomenclature of the depreciation means at annual depreciation rates, as well as the mode of calculation of depreciation, and/or the writing-off of the value of intangible and tangible investments. The depreciation base shall also be adjusted for additional revaluation value of the investments.

The acquisition value, i.e. the cost price of the intangible and tangible investments shall serve as the base for writing-off. The acquisition value of the intangible and tangible investments shall constitute the suppliers' invoice value increased by the dependent costs based on the acquisition and the bringing into the state of functional preparedness. The cost included in the cost price shall cover the direct cost of such investment and the pertaining part of the indirect costs. The cost price may also, include the expenses of the financing of the production of elements of the tangible investment until its start-up. The cost price may be considered as an investment depreciation base, but up to the acquisition price of the same or similar product or service. The depreciation base shall be adjusted for additional investments due to reconstruction, adaptation or other investments increasing the capacity or functional ability.

The base for writing off the founding investments shall be constituted of the study and research expenses, expenses for preparation and purchase of the project and other documentation, expenses for professional training and improvement, interest expenses, insurance premiums expenses, as well as other expenses relate to the founding of the Entity, i.e. the Entity's organization unit or plant. The base for writing off the delimited negative effects of the different growth of the foreign exchange rates of the foreign currencies and of the growth of the

domestic prices of the producers of industrial products shall be constituted of the amount of this delimitation determined for a specific business year. The base for writing off the basic flock shall be constituted of the difference between the market and the slaughterhouse price of the livestock. The base for writing off the intangible and tangible investments received free of charge shall be constituted of the assessed acquisition value. The writing off the intangible and tangible investments shall start after expiration of the months of the start-up in the year in which the utilization of the investment has started. As an exception, the writing off of the investments in the raising of the tangible and intangible investments (ongoing or stopped investments) shall start after expiration of the period for start-up provided in the investment survey, i.e. the revised investment survey, with which the investment (the fixed asset) should have started to be used.

The deadline to write off intangible investments, with the exception of the difference between the higher purchase value and lower book value at the time of purchasing parts or whole entities (the goodwill) and the delimited adverse effects of the different growth of the exchange rate of the foreign currencies and of the growth of the domestic prices of the producers of industrial products, as well as the rights that have a fixed period of use, may not be longer than five years.

The investments in goodwill and the delimited adverse effects shall be written off at least at the average annual rate at which the Entity has written off the present value of the fixed assets (writing off of the residual life of duration) in a year in which an investment in goodwill has been made, i.e. the Entity has determined the delimitation. The writing off of intangible and tangible investments during the year shall be calculated temporarily based on the annual depreciation account adjusted by the changes during the year. At the end of every business year, as well as at the time of status-related changes, a final depreciation account shall be drawn up. The depreciation shall be calculated by groups and individually on the intangible and tangible investments by the Nomenclature of depreciation assets.

The assessment of value of the forests shall be done according to the data determined by the stock-taking, i.e. by the assessment of the quantity of wood mass of individual kinds of trees, the depth structure and quality of the wood mass, calculated at the market prices in the nearest market-place (truck road, railway station, floating object, and the like).

Claims and the financial investments shall be assessed in the amount of the nominal value derived from the appropriate business or financial transaction. The decrease in the value of the value of the claims and the financial investments and/or their writing off shall be debited to the extraordinary expenses, and the non-agreed increase in the value shall be credited to the extraordinary income, unless otherwise provided by this Law. The adding of the amount of the calculated revaluation and the interest or the pertaining part to the profit in line with an agreement, and/or contract shall be considered as a new claim, i.e. financial investment, and the value of the corresponding claim and/or financial investment shall be increased on that basis. The due

claims and investments, as well as repayments under long-term financial investments shall be excluded from the long-term financial investments and shall be transferred to other short-term claims not later than the date of the annual balance sheet.

Inventories of materials, spare parts and goods shall be assessed at the acquisition value calculated according to the method "First in-First out (FIFO)", according to the method "Last in-First out (LIFO)", according to the method of average prices or according to the method of calculation of planned prices adjusted for the departures from the accounting period, unless otherwise regulated by another law. The acquisition price of the materials, and/or spare parts, and/or goods shall contain the net invoice value, customs duties, other import duties, taxes and other duties charged to the price of the suppliers, the transportation costs, insurance and other dependent acquisition costs. The transportation costs may also include the pertaining costs of the Entity's own transportation not exceeding the level of the price of the same or similar transportation service. The general acquisition costs shall not be considered as dependent costs, but rather as production costs and/or expenses in current period. The materials, and/or spare parts produced by the Entity shall be assessed up to their cost price, provided that this price is not higher than the net market price of the same product, and/or similar product, so that the assessment is done up to the net market price. The objects constituting the sundries, the tires, and the return packing, shall be written off according to one of the well-known and practice-accepted methods of writing off, provided that the sundries are written off at least at the rate of 20% of the acquisition value per annum.

Inventories of the unfinished and finished products shall be assessed up to the full cost price, i.e. up to the selling prices reduced by the duties and sales costs, if these prices are lower. The cost price of the inventories of the external production and finished products may also include the general costs that are not included in the production costs under conditions of production of long-term outputs and seasonal sale.

Cash shall be entered in the balance sheet according to their nominal amount. The precious metals and objects of precious metals and objects containing precious metals shall be entered in the balance sheet at least in the value derived from the price of the precious metals in the world market. The National Bank of the Republic of Macedonia shall publish in "The Official Gazette of the Republic of Macedonia" until 10 July the prices of the precious metals prevailing on 30 June, and until 10 January the prices prevailing on 31 December of the previous year, with these prices being expressed in denars, based on the average prices from three to five largest world exchanges.

The **payables** shall be entered in the liabilities of the balance sheet in the nominal amounts derived from the business and financial transactions. The reduction of the payables in relation to the nominal amounts shall be done in extra judicial settlement and the like by direct writing off. The due long-term payables shall be re-booked to the other payables not later than the date of the annual balance sheet. The Entity shall write off the short-term payables after expiration of the period of the time limit set by statute of limitations in favour of the extra income.

The payables based on securities shall be adjusted in the business books for the amounts of the interest pertaining to the coming period. Within the framework of the non-operating liability items the pre-collected and/or calculated income and costs of the current period for which a documentation base is missing shall be delayed.

2.3 Albanian Reporting

Albania has prepared a Country strategy and Action Plan in 2008 which is based on the World Bank Report (2006) on the Observance of Standards and Codes on Accounting and Auditing in Albania. This strategy, was developed by the National Steering Committee, consisted of public and private stakeholders, sets out a clear program of reforms to enhance Albania's legal framework, institutions, accounting and auditing profession as well as its accounting and auditing and business culture, to achieve high quality financial reporting. The enhancement of financial reporting should not be viewed as an objective for its own sake. But, it is much more than this and there is a need of all country's stakeholders to participate in micro level as well in macro level. High quality financial reporting is the basis of a well functioning market economy and the core of a country healthy financial system. The adoption of the International Accounting Standards (IAS) in Albania will increase transparency, comparability and accountability of financial reporting and will improve both the quality and comparability of financial information reported by public and private entities in Albania. Thus, high quality financial reporting is very progressive step and challenge for Albania and its financial system. This will promote, among other things, foreign investment in Albania.

Financial statements must be submitted annually. National Accounting Standards (NAS) and International Financial Reporting Standards (IFRS) apply for certain companies, effective January 1st, 2008. The accounting standards and reporting, for the economic entities for profit located in the territory of the Republic of Albania are governed by the Law No.9228, dated 29.04.2004, "For Accounting and Financial Reporting" (Accounting Law), in power since January 1st, 2006. The Accounting Law is complemented by the General Accounting Plan – Council of Ministers Decree No.783, dated 22.11.2006, "On the Accounting Standards and Regulations". In April 2008 was translated the whole set of International Accounting Standards, International Reporting Standards and the commentary in Albanian. In May 2008, the Minister of Finance issued a decree No.55, dates 05.05.2008, "On the announcement and the compulsory implementation of the International Accounting and Financial Reporting Standards IAS/IFRS" translated in the Albanian language.

According to Albanian National Accounting Standard 2 (NAS 2: Financial Statements Presentation, p.5), financial statements are consisted of the: Balance Sheet, Statement of Profit and Loss, Statement of Cash Flow, Statement of Changes in Equity, and Notes.

Financial statements will be prepared based on materiality concept. National Accounting Standards will not be implemented for intangibles articles (NAS 1: General Framework for preparing Financial Statements). According to paragraph 49 (NAS 1), in preparing financial statements,

importance should be given to those aspects and financial data of economic activities that are important for financial statements users, and that can effect on their economic decisions.

Following assets are known as **short-term assets**: cash and its equivalents, except in case when they cannot use within, at least 12 months after balance sheet date; assets that are predictable to realize within usual business cycle (time from buying materials that enter into process and theirs converted in cash or in other instrument that is ready to be converted in cash) of reporting economic entity (even if it longer than 12 months, for example inventories and some receivables from activity); assets held mainly for trade goals (for example financial investments held for trade); assets that expected to realize within 12 months after balance sheet date (for example, financial investments that are expected to sale, and maybe will be sale within coming 12 months). All other assets are presented as long-term assets.

A **long-term tangible asset** should be recognized in the balance sheet only if: the asset is controlled by reporting economic entity; possible future economical benefits will occur in the reporting economic entity due to the asset usage; a reliable asset cost evaluation can be performed.

Inventories are assets: held for sale in usual flow of reporting economic entity; are present in production process; in material form or acquisition for usage in production process or performing services. Inventories should go through the depreciation test at the closing date of the balance sheet. The requirement to valuate inventory with the lowest value among cost and net realizable value, obliges the reporting economic entity to record in accounting losses from depreciation in the moment when depreciation happens. The decreases to achieve the net realizable value might happen if there is a decrease in sale prices, or finalizing expenses or direct sale expenses are increased. They are cases when products are damaged before sold, or products are kept in such quantities that cannot be sold enter a reasonable period time. In such case, the inventory cost should be decreased to achieve the net realizable value.

Following liabilities are known as short-term liabilities: liabilities that will be paid within 12 months after balance sheet date (for example, short-term loans). All other liabilities are presented as long-term liabilities.

3 Methodology

As mentioned before, having the belief that once regulatory bodies adopt a financial reporting paradigm, it becomes the guiding principle for accounting regulation (Hitz, 2007), that is, standard setting, we began our research by first analyzing the foresights comprised within the IFRS concerning the matter of financial reporting and then moved forward to the four national accounting systems (the Czech, Macedonian and Albanian ones). Not only have we analyzed the three sets of regulations separately, but also emphasized the particularities found within the three sets of national GAAPs through the perspective of emerging capital markets. An empirical analysis was performed by testing the similarities and dissimilarities between the three sets of standards, taken two at a time in order to draw a well established conclusion regarding the

comparability degree existent between them. The source of information for the empirical analysis was also the information gathered by closely analyzing the regulations mentioned above which were accordingly codified and assayed by using some statistical methods which are being detailed in the chapter dealing with the comparative approach of the national GAAPs by reference to international reporting paradigms (see Appendix 1).

The findings of our study which come from analyzing formal harmonization in the area of financial reporting, are correlated to the current development stage of the national capital markets along with the international trade literature, and make some remarks on the national regulatory bodies.

4 Comparative Analysis

With the aim of identifying the eventual shift on national GAAPs towards international reporting paradigms we have performed an empirical analysis with character of comparison between the four accounting systems. For each of the identified elements we proceeded to achieve a comparison between the accounting treatment as it appears within the three accounting referential considered for analysis. Thus, for each possible and/or existent accounting treatment within at least one of the considered accounting referential we have allocated the 1 or 0 value, where the 1 value shows that the considered accounting treatment exists within the considered accounting referential, and the 0 value is given for the situation when the considered accounting treatment isn't found within the considered accounting referential (Strouhal et al., 2008).

In order to achieve the proposed comparison, we have considered that the best analysis, in the case of this type of approach, is represented by the nonparametric correlation and the association degree between two or more than two considered variables. Jaccards' association Coefficients have been used since the trade literature (Fontes et al., 2005) frequently uses this measurement instruments when an analysis at the level of national accounting regulations is aimed. On the other hand, the two Jaccard Coefficients offer the possibility of quantifying both the association degree and the dissimilarity degree between different sets of accounting standards taken into consideration for analysis.

Calculation formula for the Jaccards' Coefficients shows as follows:

$$S_{ij} = \frac{a}{a + b + c} \quad (1) \text{ or}$$

$$D_{ij} = \frac{b + c}{a + b + c} \quad (2)$$

Where,

S_{ij} represents the similarity degree between the two sets of analyzed accounting regulations;

D_{ij} represents the degree of dissimilitude or diversity between the two sets of analyzed accounting regulations; a – the number of elements

which take the 1 value for both sets of regulations;
 b – the number of elements which take the 1 value within the j set of regulations and the 0 value for the i set of regulations;
 c – the number of elements which take the 1 value within the i set of regulations and the 0 value for the j set of regulations.
 The accounting analyzed elements are therefore given the 1 value for using a certain accounting method and the 0 value for not-using that considered accounting method or treatment (Fontes et al., 2005).
 As a result of the effective measurement of the comparability degree between the Czech, Macedonian, Albanian and International (IFRS) accounting referential based on Jaccards' Coefficients we have reached the conclusion that there is a high degree of similarity between the three national GAAPs and IFRS on the approached area. Results show quite high level of similarities between analysed systems of financial reporting (see Tables 1 – 4). The major differences are given by the level of required disclosed information.

Table 1. Measurement of Similarities and Dissimilarities (CZE)

	CZE/FYROM		CZE/ALB		CZE/IFRS	
	Sij	Dij	Sij	Dij	Sij	Dij
1 Intangibles	1.000	0.000	0.333	0.667	0.667	0.333
2 PPE	1.000	0.000	1.000	0.000	0.667	0.333
3 Investment Property	1.000	0.000	1.000	0.000	0.667	0.333
4 Financial Lease	0.500	0.500	0.167	0.833	0.000	1.000
5 Inventories	0.750	0.250	1.000	0.000	1.000	0.000
6 Financial Assets and Liabilities	0.333	0.667	0.000	1.000	0.750	0.250
7 Financial Derivatives	0.250	0.750	0.250	0.750	1.000	0.000
8 Financial Statements	1.000	0.000	1.000	0.000	0.833	0.167
TOTAL	0.692	0.308	0.517	0.483	0.645	0.355

Source: our analysis

Table 2. Measurement of Similarities and Dissimilarities (other)

	FYROM/ALB		FYROM/IFRS		ALB/IFRS	
	S _I	D _I	S _J	D _J	S _J	D _J
1 Intangibles	0.333	0.667	0.667	0.333	0.250	0.750
2 PPE	1.000	0.000	0.667	0.333	0.667	0.333
3 Investment Property	1.000	0.000	0.667	0.333	0.667	0.333
4 Financial Lease	0.167	0.833	0.000	1.000	0.750	0.250
5 Inventories	0.750	0.250	0.750	0.250	1.000	0.000
6 Financial Assets and Liabilities	0.000	1.000	0.200	0.800	0.200	0.800
7 Financial Derivatives	0.000	1.000	0.250	0.750	0.250	0.750
8 Financial Statements	1.000	0.000	0.833	0.167	0.833	0.167
TOTAL	0.467	0.533	0.471	0.529	0.563	0.438

Source: our analysis

Table 3: Jaccard's Similarity Coefficients

Similarities	CZE	FYROM	ALB	IFRS
CZE	1.000	0.692	0.517	0.645
FYROM	0.692	1.000	0.467	0.471
ALB	0.517	0.467	1.000	0.563
IFRS	0.645	0.471	0.563	1.000

Source: our analysis

Table 4: Jaccard's Dissimilarity Coefficients

Dissimilarities	CZE	FYROM	ALB	IFRS
CZE	0.000	0.308	0.483	0.355
FYROM	0.308	0.000	0.533	0.529
ALB	0.483	0.533	0.000	0.438
IFRS	0.355	0.529	0.438	0.000

Source: our analysis

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5 Conclusion

The most significant problem of the financial statements and items shown is the complete inconsistency of measurement bases and the application of the historic (acquisition) cost, the fair value and the present value. At present, the principle of measurement based on the historical cost is fading out as it is gradually being replaced by the IFRS trend of reporting fair values, which are, however, difficult to measure in less transparent markets. At the same time, the reporting based on the fair value includes the hidden danger of future volatility of such values and the consequent impact of the changes on financial statements. The results of performed analysis show the high level of compatibility between Czech system and IFRS, candidate countries (especially Albania) progressed its accounting towards international referential too.

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