



Contents lists available at ScienceDirect

European Management Journal

journal homepage: www.elsevier.com/locate/emj

Financial reporting in Europe: Prospects for research

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ARTICLE INFO

Article history:

Received 20 November 2017

Accepted 24 November 2017

Available online xxx

Keywords:

Accounting in Europe

Accounting standards

Financial reporting

IFRS

Private sector accounting

Public sector accounting

ABSTRACT

This paper is a commentary on the future of financial reporting in Europe and on how research into accounting issues can be relevant to policy makers. Combining scholarship in accounting with scholarship in management can offer insight into national and global issues where accounting communicates information that affects managerial decisions at the microeconomic level and political decisions at the macroeconomic level. The paper cites examples of recent research in financial reporting and points to the current work plans of leading policy makers to illustrate the potential for researchers to influence policy directions. The context of financial reporting, nationally and globally, and the data available in the public domain, provide continued opportunities for researchers investigating accounting issues in the private sector and the public sector.

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1. Introduction

The objective of this paper is to comment on the future of financial reporting in Europe and outline some suggestions for future research that may have policy relevance. The paper explores distinct research traditions to shed new light on contemporary challenges in the broad domain of European business and management. I discuss issues in financial reporting where the research questions about accounting may be explored by reference to theories and experiences relating to business and management.

In this journal almost 25 years ago, a review of academic literature demonstrating the impediments to accounting harmonisation in Europe concluded (Blake & Amat, 1994, p. 336):

“The diversity of accounting practices in Europe is so great as to seriously impair the comparability of accounts from different countries, and creates substantial costs for European companies. Despite substantial harmonisation projects at both governmental level, through the EU, and the professional level, through IASC [the International Accounting Standards Committee], this diversity is likely to continue”.

Blake and Amat were writing at a time when discussions were taking place with a view to preparing Europe-wide accounting standards, to be issued by the European Commission (Camfferman & Zeff, 2015, p. 57). That proposal did not have support in all member states (Camfferman & Zeff, 2015). Consequently in 1995 an official Communication indicated that the European Commission

had decided to work with the IASC in strengthening International Accounting Standards (IAS) to be sufficiently robust for the needs of international capital markets (Schaub, 2005). From that initial focus on capital markets and listed companies, attention has widened to the financial information requirements of unlisted companies, and organisations in the public sector.

The paper continues in section 2 by outlining the European context for financial reporting and reviewing issues identified by recent research in listed and unlisted companies. Section 3 discusses the role of financial reporting in public sector entities. Section 4 shows how the published work plans of policy makers can provide researchers with ideas for projects with potential impact across Europe. Section 5 concludes.

2. Listed and unlisted companies in the private sector

Profit-seeking companies in the private sector of an economy may have their shares listed for trading on a stock exchange, or they may be unlisted. In both cases there is regulation that includes disclosure of financial information, because such companies enjoy a form of limited liability. However the listed companies (and some of the largest unlisted companies) have a public interest obligation, which leads to more intensive regulation of financial disclosure.

‘Financial accounting’ reports to those outside an organisation, while management accounting focuses on internal reporting. ‘Financial reporting’ is a broader description to refer to a combination of quantitative accounting statements and narrative reports. The stakeholders who are the intended recipients of financial

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reporting include owners of, and lenders to, the business in the private sector, and citizens in the public sector. Other interested parties who may be incidental recipients will include employees, suppliers, customers, taxation authorities, and state regulators. There may also be a public interest aspect. The International Accounting Standards Board (IASB) sees its primary objective as being to meet the information needs of owners and lenders, predominantly operating in capital markets, which means a focus on listed companies. More recently, it has moved towards accommodating unlisted companies by developing an accounting standard for small and medium-sized enterprises (IFRS for SMEs) based on the principles applied to listed companies but recognising some of the practicalities for SMEs.

Financial accounting is regulated at national and international levels. Parliaments, government ministries, stock market regulators, courts of law, and banking authorities have authority to examine evidence and apply penalties. Increasingly they draw on the technical expertise of the IASB as the independent standard-setting body of the International Financial Reporting Standards Foundation, a private not-for-profit foundation, established to serve the public interest. Its aim is to produce a single set of high-quality, understandable, enforceable and globally accepted accounting standards. It has no direct powers of enforcement and relies on the 150 national regimes that apply the standards.¹ Some of those countries have retained sovereignty over setting accounting standards while following the IFRS very closely. In contrast, the USA has retained its own separate accounting standards, commonly referred to as “US GAAP” (US generally accepted accounting principles), developed by the Financial Accounting Standards Board (FASB).

2.1. The European context

In the European Union (EU), a Regulation taking effect in 2005 requires that all group companies listed on any stock exchange must apply IFRS in their financial reporting. The standards are referred to as “EU endorsed IFRS” because there is a two-stage process of technical and political scrutiny to be applied before an IFRS can be endorsed for use by EU companies. Technical scrutiny is applied by EFRAG (the European Financial Reporting Advisory Group), which is a private association established in 2001 with the encouragement of the European Commission to serve the public interest. Its member organisations are European stakeholders and national organisations having knowledge and interest in the development of IFRS and how they contribute to the efficiency of capital markets. Political scrutiny is applied by the Accounting Regulatory Committee (ARC) comprising representatives of all member states.

This process of endorsement has occasionally delayed implementation in the EU and has seen relatively infrequent, but high profile, challenges from either the Commission or the European Parliament. The time lag sometimes creates an inconvenience for companies in preparing their financial statements. Individual companies in EU member states, and those that are not listed on a stock exchange continue to follow the national regulations of the country in which they are based. Beyond the EU, most countries across Europe have now largely moved to requiring IFRS for listed companies.

¹ A profile of the application of IFRS across jurisdictions is provided by the IASB on its website: <http://www.iasb.org/use-around-the-world/use-of-ifs-standards-by-jurisdiction/>. Accessed 03.10.17. A commentary giving more detail on financial reporting frameworks is provided on the website by Deloitte: <https://www.iasplus.com/en/jurisdictions>. Accessed 03.10.17.

Researchers have identified issues in individual countries and across Europe more widely. Research questions illustrated in this section are:

- Did the introduction of IFRS in 2005 lead to more effective accounting information for listed companies (section 2.2)?
- How are countries in Europe adapting IFRS for the needs of unlisted companies (section 2.3)?
- What are the political, economic and institutional influences for supporting or resisting change (section 2.4)?
- What is the role of narrative reporting in communication between management and stakeholders (section 2.5)?

One challenge to the researcher is to identify theories and a valid research design that will make a contribution to knowledge in the field of study. Papers that are purely descriptive, although they may recount an interesting scenario, do not generally survive the rigours of academic review for leading journals. However interdisciplinary research methodologies may unlock some interesting new insights, based on evidence.

Another challenge to the researcher is to provide policy-relevant findings which will interest policy makers as they look forward in their planning. As researchers, we are taught to look back on the evidence and apply our skills in research methods and analysis to draw valid inferences and conclusions that contribute new knowledge and understanding. The evidence is drawn from past experience. Those organisations that take responsibility for regulating and guiding best practice in accounting must look to the future while having regard for prior evidence. In looking back how do we look forward? Positivist or interpretivist methodologies tend to be the domains of the researchers. In contrast, normative methodologies are applied by the policy makers and standard setters. They start with a set of beliefs and then mandate practices. Effective research will seek to have an influence on those beliefs.

2.2. IFRS and listed companies

In exploring whether the introduction of IFRS in 2005 led to more effective accounting information for listed companies, initially researchers focused on effectiveness for stock market investment. With the passage of time and changing economic conditions, interest has extended to the need for information that supports wider needs in the management of business.

The introduction of mandatory IFRS by Regulation in all EU member states from January 2005, superseding national accounting standards, provided a very obvious event on which to base studies of change. There were some complexities but these also provided opportunities for researchers. The complexities arose because some countries had allowed voluntary adoption of IFRS by listed companies in their group accounts, where those companies also had a listing on a foreign stock exchange, usually a US exchange. Such voluntary use of IFRS had been permitted in particular in France and in Germany. The German stock market was expanding rapidly at the time and provided sufficiently large samples of voluntary adoption of IFRS for researchers to explore. In consequence, there was a flurry of research papers around the question: Did the introduction of mandatory IFRS in 2005 improve the effectiveness of financial accounting information?

Tests of this question were based on stock market reaction to the introduction of IFRS, using statistical methods such as event studies (e.g. Armstrong, Barth, Jagolinzer, & Riedl, 2010), value relevance (e.g. Tsilavoutas, André, & Evans, 2012), earnings quality comparisons (e.g. Christensen, Lee, Walker, & Zeng, 2015) effects on cost of capital (e.g. Li, 2010) and the accuracy of analysts' forecasts (e.g. Horton, Serafeim, & Serafeim, 2013). Typical conclusions from such

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