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Auditing Risks in Transition Economies

A Study in the Post-socialist Auditing Environment

Master thesis in Business Administration
Financial Accounting and Analysis of Corporation
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ABSTRACT

Thesis in Business Administration, Gothenburg School of Economics and Commercial Law, Financial Accounting and Analysis of Corporations, Master Thesis, Autumn 2003

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Title: Auditing risks in transition economies – A study in the post-socialist auditing environment

Problem area: When preparing financial reports of entities in transition economies certain problems arise that are solely a product of the past economic system and hence an situation which exists only in the states that are going through a transition from a planned to a market economy. The problem area of this thesis is from the auditor's perspective when preparing the financial reports. The thesis will analyse how the old – the Soviet socialist – system of reporting has influenced the new.

Purpose: The purpose of this thesis is to investigate the specific auditing problems that the former Soviet type planned economy has caused. The study will identify the fundamental differences and the liabilities of a transition from a planned to a market economy.

Delimitation: This research will not focus on the political transition or the macro economic changes and the resulting benefits from a sound financial reporting system. The thesis will rather look at the problems from an auditor's perspective and the factors which he or she may consider important.

Method: The primary research is carried out as a qualitative study by means of four interviews with accountants and a researcher who have relevant experience. The empirical study has been analysed with reference to the theoretical framework.

Conclusions: It has been concluded that there exist two categories of auditing problems in the transition economies. Category one represents those problems which are directly linked to the legacy of the old system such as the old accounting procedures and the insufficient internal control systems. Category two represents those problems which are more a product of the transition from a planned to a market economy. These problems include the economics of transition, legal aspects, and the neglect of the 'going concern' principle to name a few.

Recommended future research: The authors recommend future research to be carried out in two areas which have been mentioned in this thesis. Firstly, the authors recommend a study concerning if detail tests have become more common or important since the recent accounting and auditing scandals. Secondly, the authors recommend future studies to determine how a sound financial reporting system would benefit and encourage the transition from a planned to a market economy.

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1. INTRODUCTION

This chapter introduces the subject of the thesis and presents the problem area which is going to be examined and the purpose of the study. Furthermore, this chapter will also outline the delimitations and the disposition of the thesis.

1.1 Background

After the fall of the Berlin Wall in 1989 the old Soviet regime started to dissolve. Poland had already started their transition towards a market economy and in September 1991, the three Baltic States, Estonia, Latvia and Lithuania, regained their international recognition as independent countries in the United Nations (Bailey, Alver, Mackevicius and Paupa 1995, p.686). The rest of the Soviet Union and the other socialist countries in Eastern Europe followed suit and started to develop a market economy. They embarked up on a transition from the former centrally planned economies to a market economy in one form or another. Prior to the transition all entities had been controlled by the state (Nikitin 1966 cited Gardner 1998, p.347):

Social ownership does away with anarchy of production and spontaneity, and production is developed in the interest of the people as a whole. This being so, the national economy can be developed only on planned lines.

The planned economy's fundamentals are that wages, prices and production are determined by the planning authority, i.e., there is no classical supply and demand which assists the economy. To take a radical step away from the social ownership and the planned economy, entities must be privatised and the markets made open to spontaneity and the price mechanism. Thus there will be a need for market values and relevant information must be produced. In the former Soviet Union the user of the financial reports was the state and the information was very different from what was being produced in Western Europe, the US or other market economies. This lack of relevant information resulted in an immediate need for construction and implementation of a post-Soviet accounting system, a need that has been satisfied although differently in different states (Bailey *et al.* 1995, p.687).

However, independence and new regulations do not automatically transform a former planned economy to a market economy. The mentality and habits developed during socialism live on: *'people who had lived for so long under communism are now ill-equipped to operate in a market economy'* (Shiller, Boycko and Korobov 1992 cited Kizilyalli 1998, p.112). This behavioural problem or legacy from the past implies that even if a well functioning financial reporting system was developed and successfully implemented, the pre-transition mentality and habits will still have an effect on the representation and auditing of entities in transition economies. The transition period is not a phase that will end after the fundamentals of a market economy have been implemented. One of the most harmful legacies of the past – the former planned

economy – is the semi-legal or illegal ‘parallel’ that developed within the state sector in all socialist countries also known as ‘shadow’ (Lavigne 1999, pp.9-10). The shadow was developed as a substitute to a market and was based on corruption and large scale stealing of state property. One of the most important attributes of the ‘shadow’ activities is that it is socially accepted and has survived through the transition and in some cases developed in to mafia activities.

The transition to a market economy can take decades to fully be implemented. The time it takes is, among other factors, also dependent on the domestic political stability. Which type of market economy is the aim of the transition state: Anglo-American capitalism, mixed economy or democratic socialism? Are all parties involved focused on the same goal? The shadow activities described above can also have a negative influence on the transition, and can delay its implementation. The longer the time, the more likely it is that alternative markets will develop and more problems that will be in conflict with the transition process will occur. This in turn may have implications for the preparation of the financial accounts and reports.

The problems arising during the transition period have resulted in a demand for a well qualified accounting profession and for a financial reporting system. However, when analysing the risks associated with financial reporting of an entity in a transition economy, it is important to see that they differ from those of entities in a stable economy. Even if the former planned economy has successfully implemented, for example, IASB’s standards, the legacies of the past will have a significant role to play when preparing the financial accounts and reports. There will be the obvious differences in the preparation and contents of the financial accounts and reports and the changes of users of this information. Also, the legacies of the former socialist system and the lack of certain criteria which is needed for assumptions such as market value may haunt the ‘true and fair view’ of the information.

It is the authors’ view and argument that the transition economies’ demand for auditing differs from that of traditional accounting. The subject of transition economies and their financial reporting and the preparation of such reports are of great interest not only for the states themselves but also for the rest of the world. Western companies put in large amounts of foreign direct investments in developing countries. This investment calls for a sound reporting system which in turn is dependant on the preparation of the accounts.

1.2 Problem Area

The problem area which this thesis will examine is the problems from an auditor’s perspective that arise in transition economies when preparing the financial reports. What problems has the past system inflicted on the subject of financial reports? The thesis will analyse how the old – the Soviet socialist – system of reporting has influenced the new. By this the authors do not mean the structure and contents of the financial reports but rather the problem inflicted on the preparation of accounts and reports as a result of the legacies that the old system has carried forward. When preparing financial reports of entities in these transition economies there are bound to be certain problems arising that are solely a product of the past economic system and hence an attribute which exists only in the states that are going through a transition from a planned to a market economy.

Even if the theoretical financial reporting framework of a traditional market economy is implemented, the people and a large proportion of the entities are products of the socialist political climate. Even if the political party and the economic framework have changed, the people and the old attitude will not change easily. Will the socially accepted 'shadow' activities have an effect on the preparation of financial accounts? Is there a functioning market against which market value of assets and liabilities can be measured? Is the management competent and functional in a post-Soviet environment? Is the internal accounting and reporting sufficient? Has the new system been successfully implemented? Is there a competent accounting profession?

As discussed above, there are many potential problems regarding the preparation and reporting of financial accounts in transition economies. This is an area which the authors find interesting and has resulted in the following research question:

What risks and problems related to auditing of financial reports has the former Soviet type planned economy regime caused the transition economies?

1.3 Purpose

The purpose of this thesis is to investigate the specific auditing problems that the former Soviet type planned economy has caused for the financial reporting in a transition economy. The thesis will in the theoretical framework explain the theoretical features of financial reporting and auditing. Furthermore, it will also describe the theoretical problems that may occur in a transition economy with regards to financial accounting and auditing. This will identify the fundamental differences and the liabilities of a transition from one system to another. This study will identify the problems which the old system has carried forward and how these have influenced the preparation of financial accounts and reports. Furthermore, the purpose is also to investigate and determine the actions undertaken by auditors to prevent or minimise these problems.

1.4 Delimitation

This research will not focus on the political transition or the macro economic changes and how these have benefited from a sound financial reporting system. The study will rather look at the problems from an auditor's perspective and the factors which he or she may consider important. Furthermore, this thesis will focus its research on the former Soviet type planned economies in Europe and not use examples or empirical studies which reflect the situation outside this area. The research will not only take one or two countries into consideration, it will rather study the concept of transition in the former Soviet type planned economies. Therefore the study will include both the former Soviet Union states and other transition economies such as Romania. The reason for this is that the authors want to collect as much information as possible from the rather different situation in which the transition economies find themselves and analyse and draw conclusions about the problems which are exclusive to transition economies and not to a specific country that happens to be in a transition.

1.5 Disposition

- Chapter 2** This chapter gives the reader a description of the research methods used in this thesis. It describes the criteria by which the secondary data has been chosen and the problems faced when dealing with those criteria. This chapter also explains the choice of primary data or empirical study, and in the way it was prepared, carried out and analysed.
- Chapter 3** This chapter gives the reader a description of the fundamental principles of financial reporting in a market economy. Furthermore, it describes and explains the purpose and methodology of the reporting on financial performance in a former Soviet style planned economy. Finally, the theoretical problems which may arise in a transition economy with regards to the preparation and reporting of financial accounts are described.
- Chapter 4** This chapter contains the empirical study which the authors have carried out. The findings of the empirical study will be outlined and unedited (with the exceptions of translations). Each interview will start with a short presentation of the interviewee.
- Chapter 5** This chapter presents the reader with the analyses and discussions which the authors have made with reference to the empirical study described in chapter 2. It analyses the problems which the empirical study has shown and explains how they differ from each other and from the theory.
- Chapter 6** This chapter presents the final conclusions which the authors have identified from the analyses. It concludes with an identification of the explicit problems related to auditing in transition economies and how they are dealt with. It also gives suggestions on further studies on the subject with regards to questions outside the delimitations of research which have arisen during the process of the thesis.

2. METHOD

This chapter gives the reader a thorough description of the research methods used in this thesis. It will describe the criteria by which the secondary data has been chosen and the problems faced when dealing with those criteria. This chapter will also explain the choice of primary data or empirical study, and the way in which it was prepared, implemented and analysed.

2.1 Method Overview

The theoretical framework of this thesis was developed as the secondary research took place and the authors gained more in-depth knowledge of the subject(s) which are the basis for the theoretical framework. One could argue that the authors have, through the secondary research, created a hypothesis regarding potential exclusive auditing problems in the transition environment. The secondary research focuses on the role of financial reporting and auditing in a traditional Western economy and the former Soviet type planned economy and their accounting traditions. The purpose of this is to identify potential problems regarding auditing which may arise in a country which is experiencing a transition from a planned to a market economy.

The primary research is carried out by means of interviews with accountants and a researcher who have relevant experience. Where possible the interviews are done in person but as some of the interviewees are living in foreign countries it has not been feasible to do the interviews in person and an alternative way of communication has been used.

The study also consists of a thorough analysis of the findings done in the interviews. The problems which have been illuminated in each interview will be compared with that of the others. These findings will also be compared to the theoretical framework and the differences will be examined. Moreover, the analysis will also serve to identify the recommendations or solutions to the identified problems.

The citing references used in this thesis are based on the British Standards of the Harvard system (Bournemouth University 2003).

2.2 Secondary Research

The secondary research in this thesis serves as a basis for the empirical study. The interview guides are based on the problems identified in the theoretical framework. According to what Backman (1998, p.23) refers to as the traditional approach, secondary research can be viewed as an attempt to infer or 'guess' what problems may occur in a transition economy with reference to auditing. This describes very well the method by which the theoretical framework in this thesis is developed. Through the secondary research, there have been no findings which can be directly linked to this

thesis. This has resulted in that the authors have had the privilege of developing the theoretical framework from the theories regarding financial reporting and auditing and put them into context with the political structure in the former Soviet Union and the accounting system of the latter. The various problems arising in a transition economy and which the authors have regarded as relevant have also been taken into consideration. However, the function of secondary research is not merely a 'guessing device'. Secondary research also determines and explains the various theoretical procedures and methods available to the topic under investigation such as traditional auditing problems in Western economies. The secondary research is reported in an exploratory and descriptive manner where the theory describes the problems associated with the research and possible ways of dealing with such problems.

The choice of literature has been to a large extent based on previous knowledge of existing literature on the subject. However, the authors have extended the list of references through additional research at the libraries of Gothenburg School of Economics and Commercial Law and Lund University. This research has contributed to a more complex literature list, consisting principally of text books and articles and, to a lesser extent, internet references.

The theories studied and explained in the secondary research were chosen because of their fundamentality. However, the literary references will also include more in-depth descriptions on the subject of auditing and related problems. The theoretical chapter is therefore not based on a pre-determined model. It has rather emerged as a general knowledge of the subject has increased the authors' understanding of the different theories and problems surrounding transition economies, accounting and auditing.

The choices of secondary sources are based on the following criteria:

- correspondence to the purpose of the text;
- the overall security of the context of the source;
- the thesis authors' ability to understand the theory in a manner which gives justification to the source; and
- the original author's subjective perspective.

(Holme and Solvang 1991, p.147)

The criteria described above are fundamental to the choice of secondary literature in this thesis. The purpose of the theoretical literature employed in this thesis has been educational and/or informational. Since some of the literature that has been accounted for could be considered biased, (such as articles written from a critical perspective), the authors have taken this into consideration and, where possible, put it into context. Because some of the literature used in the secondary studies was written up to three decades ago the authors have undertaken a historical view of the original context of the source.

2.3 Primary Research

The primary or empirical study in this thesis is a qualitative study. By this it is meant that the results of the research will not be presented in figures or numbers but rather through holistic analysis. In other words, the purpose of the research is not to prove a hypothesis by deductive methods represented in a mathematical manner (Strauss and

Corbin 1998, p.11). The primary research is undertaken by means of four qualitative interviews by which the authors will identify the theoretical framework in practice based on the interviewees' practical experience.

However, the authors have experienced some problems of getting in contact with interviewees. The subject is not something that any accountant could answer questions about; rather it is more of a specialist subject. Some accounting firms which the authors have got in contact with have simply answered that they do not have anyone who could possibly know anything on the subject. This surprised the authors because all the big accounting firms have offices in the former Soviet Union and else where in Eastern Europe.

2.3.1 Choice of Interviewee

Two of the interviewees the authors got in contact with via their offices in Gothenburg. However, the initial contact was not the one that finally resulted in an interview. In one accounting firm the authors had had previous contact with one of the accountants but were given a new name which would suit better for the interview. This snowball effect repeated itself in another big accounting firm and we got in contact with an accountant who is living in the former east block. This word of mouth effect resulted in interviewees which are all well informed and have the relevant experience in the field of our study.

The third interviewee we got in contact with via a friend from Latvia who is a fellow student at Gothenburg School of Economics and Commercial Law. She had earlier done comparable research on the subject of Swedish and Latvian accounting procedures and was willing to give us the names and e-mail addresses of her contact persons in Latvia. This gave the authors the opportunity to interview a person who had been in a transition economy more or less since the start of the transition and who had a somewhat different background than the other interviewees.

The fourth interviewee, who is a researcher and has worked with training of management and entrepreneurs in Lithuania, the authors got in contact with after several phone calls to lecturers at the department of business administration at Gothenburg School of Economics and Commercial Law. The teachers at the business economics department forwarded us to other lecturers and researchers and the process continued until a researcher was found who possesses the specific knowledge required for this thesis. The purpose of this interview is to get another view of the environment in the transition economies.

2.3.2 Interview Method

The type of interviews used in the research is what Roos (1984, pp.3-4) calls an 'interview guide'. This type of interview provides the interviewee with an idea of the topics that will be discussed and a list of problem areas and other questions that the interview will focus on. It does not, however, give the interviewee a standardised interview with set questions. The interview guide is a mere instrument used in order to prepare the interviewee so that he or she can answer the questions thoroughly and contribute to the research as much as possible.

The same interview guide, see Appendix 1, was used when conducting all four interviews. However, as interviewee number four, the academic researcher, has more experience in management training and management behaviour, than in financial accounting, the same interview guide was used but with a shift in focus from accounting, to focusing mainly on management questions and questions regarding management behaviour and environment.

In order to get as thorough information as possible the interviews were followed up depending on need. This is a procedure which enabled the authors to review the preceding interview and if necessary prepare further questions that they did not anticipate. The interviews were carried out in a conversational manner, using speaker phones when necessary or otherwise face to face.

The principal benefit of 'eye contact' during the interview is the ability to read the interviewee's body language thus increasing the reliability of the conversation. The interview was also recorded to increase the validity of the research. However, the authors firmly believe that an interview carried out by means of telecommunications can give very reliable information and that the lack of eye contact, analysis of body language for example, will not jeopardise the results of the research, i.e. this type of interview can claim almost equal validity to one done in person because of the conversational manner in which they are carried out. However, an interview done by means of telecommunications will not create the same atmosphere as an interview done face to face. The interviewee may not feel as comfortable as he or she would have done meeting the interviewers in person. The authors of this study are aware of this problem and have done their best to ensure the interviewee is comfortable and to achieve the required atmosphere. This was attempted through preliminary 'small talk' which created a less formal environment. The follow-up questions which arose after the initial interview were communicated via telephone and e-mails.

Furthermore, all the interviewees in the thesis are anonymous. The reason for this is that some of the subjects discussed during the interviews are very delicate and in order for the interviewees to be able to answer as truthfully as possible the interviewees were made anonymous. However, the authors do not consider that the interviewee's anonymity will affect the reliability and validity of the thesis negatively, as the interviewees would feel more comfortable and being able to speak more freely, than otherwise possible when discussing the delicate subjects.

The interviews took place on the 28th of November, the 3rd of December, the 4th of December and the 22nd of December in 2003. Both authors of this thesis were present at the interviews with the exception of the interview that took place on December the 22nd at which only one of the authors was present. The interviews lasted for approximately one hour each excluding follow-up questions.

2.3.3 Analysis Method

The comparative technique used in the analysis chapter is what Strauss and Corbin (1998, pp.95-97) call systematic comparison. With this technique the authors will compare an incident in the interview data to a theoretical incident that they have recalled from their secondary research. The purpose of these analyses is to make the researcher more sensitive to parts of the data which could otherwise have been

overlooked. The analyses are not interested in the political problems or problems regarding the implementation of a new financial reporting and accounting system in the transition economies. Rather, the research and analysis focuses on how the old system and its related traditions have affected the auditing procedures in the current situation. Therefore, the comparative technique has been chosen as a means of analysis in which the theoretical framework and the interviews are compared.

2.3.4 Reliability and Validity

2.3.4.1 Reliability

By reliability the authors refers to the level of correct information taken from the sources, i.e. whether or not the information is compatible to reality. In order to increase the reliability of the interviews, the authors have used recording instruments to ensure that their perception of the answers is as close as possible to the interviewees' answers. The recording also enables the interviewer to focus entirely on the interviewee, hence enabling the interview to run smoother and to keep the conversation on the subject. In order to further increase reliability the interviewees will receive a copy of the interviews, after they have been translated, as soon as possible. This will enable the interviewees to verify that the content of the interviews are correct and therefore minimise personal interpretations of the answers. Furthermore, the authors have been cautious of any bias that may exist in the literature to ensure reliability throughout the research.

2.3.4.2 Validity

By validity the authors refer to how valid the information collected in the research is in order to answer the question stated for this thesis. As a principal rule, attaining an adequate level of validity is less of a problem in qualitative studies compared to quantitative studies (Holme and Solvang 1991, p.94). In a qualitative study such as this, the researchers have a close relationship with the object(s) under examination. During the interviews the authors have been able to control the interview so that the outcome would be relevant to the research and thus ensured the validity of the information gained from these interviews. The interviewees have a thorough knowledge of the subject and many years of experience which are also necessary to attain validity.

2.3.5 Method Discussion

The elimination of a quantitative research seemed a logical step in the early process of the methodology. A quantitative research could not have given the in-depth information which the authors considered necessary for this thesis. The nature of this thesis – the lack of existing information which is directly linked to the problem area – has put a demand on the research which eliminates a quantitative study. Because the research does not attempt to 'trick' or put the interviewee in an awkward position where his non-verbal reaction might have been of interest, the authors do not consider that the means by which the interview was carried out eliminates the purpose or decreases the reliability or validity. The authors do, however, recognise the importance of body language and other non-verbal information although they do not consider it of particular value for this research.

Some writers such as Stake (1994 cited Silverman 2000, pp.102-103) argue that qualitative studies should never attempt to generalise (its) findings, but rather view the research as a purely descriptive study. However, the notion that qualitative studies should not be able to sustain a generalisation beyond the given situation in the research undertaken has been opposed by many qualitative researchers. According to Silverman (2001, pp.249-254) one possible answer to the question of generalisation of qualitative research is to '*combine qualitative research with quantitative measures of population*'. Hammersley (1992 cited Silverman 2001, p.249) suggests one (among others) method by which an attempt can be made to generalise from the analysis of one single study. This is to obtain information about the relevant aspects of the population and compare them to the findings done in the qualitative study. This implies that, in order to generalise the results in this thesis, one has to carry out a quantitative research by means of researching a greater number of accountants in various transition economies with a standardised questionnaire with set questions based on the results of this research.

It is, however, the authors' belief that the findings in this thesis can be generalised to suit a greater population. The reasons for this is that firstly, the interviewees have the relevant experience and are, as far as the authors know, not significantly biased in any way. Secondly, the interviewees have similar but not identical backgrounds. The subjects of the interviews come from different accounting firms and have audited different companies in transition economies. This implies that they have extensive knowledge and experience which suggests that the findings could be generalised. The interviewees have, in their specific field, more than a few weeks' experience of a single case. All the interviewees, with the exception of interviewee four, have been involved in several audits and/or due diligences. This, the authors argue, is more important with regards to generalisation than the number of interviewees.

The research could, however, be criticised because the generalisation of the results are not based on abstract concepts. The topic of the research is new and the authors have not found any previous research which could have been used to structure the theoretical framework and thus enabled the analysis to include any abstract concepts. The one factor which could undermine generalisation of this research is the low number of interviewees. The authors do, however, believe that by narrowing the research the authors could more clearly focus on the specific topic that the research is to cover. Moreover, the authors considered the quality of the interviewees more important than the quantity.

One problem the authors have had to deal with is that face-to-face interviews have not always been possible. This may discredit the information gained from the interview but the authors firmly believe that the telephone interviews have resulted in very reliable information which could be used for sound conclusions and generalisation.

3. THEORETICAL FRAMEWORK

This chapter explains the theoretical framework on which the empirical study and analyses are based. First the general theory of accounting as developed on the Anglo-American and continental Europe models are explained, followed by comments on the general risks and theory regarding auditing. Furthermore, the overall structure of the economic planning system in the former Soviet Union will be illustrated and the theory behind their accounting system. This is followed by a description of the accounting practices in the former Soviet Union.

3.1 The Conceptual Framework for Financial Reporting

A conceptual framework for financial reporting sets out the concepts that underlie the preparation and presentation of financial statements. These theoretical concepts are used for both developing new reporting standards and evaluating existing ones. The conceptual framework for financial reporting will therefore form the theoretical basis for assessing which transactions or events that should be accounted for. The conceptual framework will also determine how these transactions or events should be measured and how they should be presented to the user. In other words, the conceptual framework for financial reporting is accounting theory which real practical problems could be tested against (Davies, Paterson and Wilson 1999, p.53).

In the next sections the objectives of financial reporting will be described from the viewpoint of both the International Accounting Standards Board (IASB), which emerged from the restructuring of the International Accounting Standards Committee's board in 2001, and the Financial Accounting Standards Board (FASB) in the US. The viewpoints of IASB and FASB have been chosen as they are the two most authoritative bodies on accounting standards, whose rules are used by many international companies, and who have written accounting frameworks which set out the conceptual frameworks for financial reporting. Although the countries in the former Soviet Union and Eastern Europe prepare financial statements in accordance with International Accounting Standards (IAS) promulgated by the IASB, the thesis also recognizes the importance of FASB viewpoint in the matter.

3.1.1 The Objectives of Financial Reporting

Financial reporting is designed to provide a picture of the overall financial position of an entity. The most important principle of financial reporting is to provide information that is useful to those for whom it is prepared (Atrill and McLaney 1999a, p.19). In order for financial reporting to supply information for decision making, it requires proper disclosure of financial data and other relevant information. To achieve the proper disclosure of financial information, one has to consider and answer the following three questions (Hendriksen and Van Breda 2001, p.851):

1. Who are the users of financial statements?

2. What is the purpose of the information?
3. How much information should be disclosed?

3.1.1.1 Who are the Users of Financial Statements?

There are many potential users of financial statements. There are different groups which have a direct or an indirect interest and relationship with a business entity. These different groups may consist of, for example, suppliers of capital, i.e. investors, suppliers of other resources, employees, customers and government agencies. However, this list of users is not explicitly of parties currently engaged in a relationship with the entity but also users with a potential relationship, e.g. people considering making an investment. Anyone with a relationship to the entity (the users) can be affected by what happens to the business and hence has an interest in receiving information about it (Rutherford 2000, p.12).

The users of financial reporting identified above vary in importance, depending on where the information is produced. In the continental Europe accounting tradition, the financial reports are directed to large owners, the state and employees. To quote the IASB (2001, p.56):

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.

The continental Europe tradition differs from the Anglo-American accounting tradition, which places a greater emphasis on creditors and current shareholders, as well as potential future shareholders as the users of financial reporting. To quote the FASB (1978, p.5):

Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions.

As the two approaches focus on different types of users, the disclosure, in respect of financial information, will differ to some extent as different users need different information. However, as seen above, both the IASB's and the FASB's quotations are very similar as the financial statements should provide information useful for economic or rational decisions.

3.1.1.2 What is the Purpose of the Information?

The information disclosed in the financial statements serves different purposes depending on the user. According to the IASB (2001, p.54):

The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public.

The decisions to be made by the investors are relatively straightforward and they need information to determine the financial return they will receive from the investment. The information is used by the investors to evaluate the past financial performance of the

business entity, for example, to determine the effectiveness of management, and to predict future performance of the entity (Rutherford 2000, p.14).

Creditors have a legal right to be paid interest when due and generally they have a right to receive a rate of return depending on the loan agreement. However, this legal right to interest and a rate of return is of little interest if the business entity is in a position where paying their debts is impossible. Therefore, creditors use the financial information to evaluate the performance and future prospects of the business entity in order to determine the risks associated with lending money (Rutherford 2000, p.14).

Shareholders and sometimes creditors can also use the financial information to make decisions regarding potential hiring, firing, and compensation of management and to be involved in major changes in the business entity. The usage of financial information is relatively easy to see regarding investors and creditors and hence both the IASB and the FASB makes the similar general assumptions that information which is useful for them will be useful for other users.

Suppliers who supply goods and services to the business entity will be concerned with the risk of not being paid and whether to build or adopt existing production capacity to facilitate special demands from the customer. Furthermore, both suppliers and customers have an interest in evaluating the financial position of the business entity to determine if the business will continue to purchase from them, or supply to them, for example, if they need to set up special equipment for distribution, and hence there is a risk of some loss if the business entity cannot honour the contract (International Accounting Standards Committee 2001, pp.54-55).

Employees may use the financial information in order to evaluate how secure their employment is, and what wage increase to seek. This is based on the anticipated future economic position of the company and the information might tell the employee to seek work elsewhere or to press for a pay raise.

Furthermore, the governments and their agencies use the information, for example, to regulate the activities of the enterprise, determine its taxation and other similar activities.

3.1.1.3 How Much Information Should be Disclosed?

How much information to be disclosed is dependent on the user and the user's expertise together with the desirable standards deemed appropriate. One usually talks about three concepts of disclosure: *adequate*, *fair* and *full*. *Adequate disclosure* is the most commonly used and it implies a minimum amount of disclosure with the objective of not making the statements misleading. The expression *fair disclosure* refers to providing equal treatment for all potential users of financial reports and *full disclosure* implies the presentation of all relevant information (Hendriksen and Van Breda 2001, p.856).

However, because it is difficult, if not impossible, to say exactly what is adequate, fair and full disclosure, accounting rules normally indicate the required specific disclosure, depending on the nature of the financial item or condition.

3.1.1.4 Qualitative Characteristics

Accountants provide financial information to the various users identified above. The quality of the accounting information produced is determined by the extent to which the information needs of the various groups are met. It can be argued that the financial information needs certain qualitative characteristics in order to be useful. Both the IASB and the FASB have identified virtually the same qualitative characteristics. These are (International Accounting Standards Committee 2001, pp.60-65):

1. **Relevance.** Accounting information must be able to have a bearing on the matter at hand. If the information does not influence the decision, there is no really point in disclosing it. The information may be relevant, for example, by affecting goals, by affecting understanding and by affecting decisions.
2. **Reliability.** The quality of information should be free from any material error or bias. The information should faithfully represent what it is supposed to represent.
3. **Comparability.** The usefulness of accounting information is enhanced if it is possible to compare one entity with another or with the same entity over time, i.e. items which are basically the same should be treated in the same manner.
4. **Understandability.** The financial reports should be expressed as clearly as possible and understood by whom they are aimed for. Moreover, if users cannot perceive the significance of information they will not be able to use it appropriately.
5. **Timeliness.** Accounting information should be available in reasonable time intervals. The time elapsed between the end of the accounting period and the actual production of the report should not be too long.

As seen in Figure 1, the first two characteristics, relevance and reliability, are what make the accounting information useful for the user. The last three characteristics, comparability, understandability and timeliness, are really concerned with how useful the accounting information will be and hence will limit it. An example of this is that relevant information for a decision may cease to be relevant if the information is not presented at the right time. There is also a sixth characteristic (cost/benefit) presented in Figure 1, which is very important. When producing information one has to consider the cost/benefit issue. Is the additional financial information worth producing? (Atrill and McLaney 1999b, p.6)

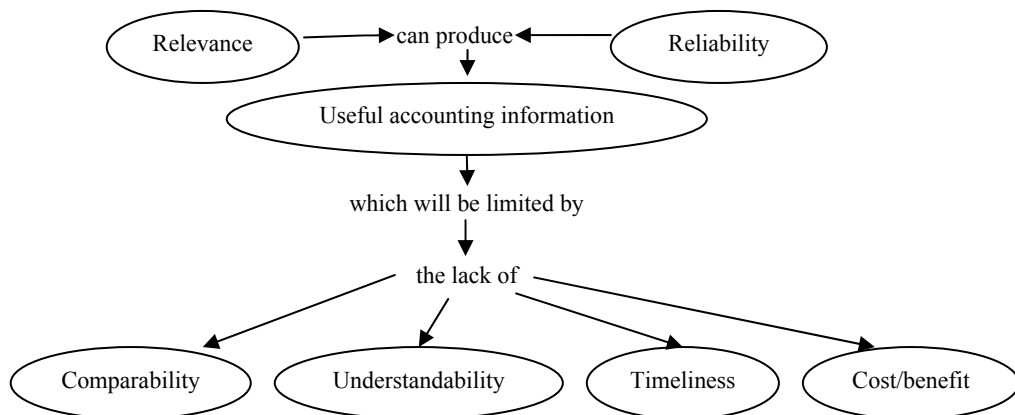


Figure 1 - The characteristics which influence the usefulness of accounting information
Source: Atrill and McLaney 1999b, p.8.

3.2 The Auditing Process

The auditing process will be described from an international auditing point of view but the thesis recognizes that individual countries have their own auditing rules. The international standard setting body used in the thesis is the International Federation of Accountants (IFAC), who issue International Standards on Auditing (ISA). IFAC is an international organizations established by the accounting profession in 1973 to 'protect the public interest by encouraging high quality practices by the world's accountants' (International Federation of Accountants 2003a). Although the thesis focuses on an international perspective it is important to recognize the work conducted by the American Institute of Certified Public Accountants (AICPA) who issue Statement on Auditing Standards (SAS) in the United States.

3.2.1 What is Auditing?

Some companies are required to have an audit and some companies choose to have an audit to satisfy lender requirements, tax requirements or investor requirements. The auditor's main duty is to determine whether the recorded information properly reflects the events and actions that occurred in the accounting period, i.e. do the statements do what they are supposed to do, namely to show a true and fair view and comply with accounting standards requirements (Davies *et al.* 1999, p.236). According to IFAC's International Standard on Auditing 200 (2003b, p.3) the objective of auditing financial statements is:

...to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrases used to express an auditor's opinion are 'give a true and fair view' or 'present fairly, in all material respects', which are equivalent terms.

The problem in IFAC definition of an audit is according to Hayes, Schilder, Dassen and Wallage (1999, p.7) that auditors believe that the terms 'true and fair view' and 'present fairly' are not the same. In the term, 'true and fair', view the enterprise has the possibility to deviate from existing law and regulation, under the circumstances that it provides a 'true' view, while the term 'present fairly' means in accordance with law and regulations.

Moreover, another definition of an audit can be found in the American Accounting Association's statement of basic auditing concept (1973, p.2):

An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users.

When conducting an audit, the information has to be in a *verifiable form* in order for the auditor to evaluate the information. This implies that the quantifiable information can take different forms. There are different criteria for the auditor when evaluating quantifiable information. For example, when auditing historical financial statements, the criteria are usually generally accepted accounting principles (Arens and Loebbecke 1991, p.2).

The *evidence* in the auditing process is according to IFAC's International Standards on Auditing 500 (2003c, p.3):

...all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in accounting records underlying the financial statements and other information.

Evidence can take many forms such as oral testimony, written communication and observations by the auditor. The process of determining the amount of evidence necessary for evaluating the financial statements is critical for a successful audit (Hayes *et al.* 1999, p.9).

The auditor must be an *independent, qualified and competent* person to know the amount of evidence necessary for evaluating financial information and for reaching a proper conclusion after the evidence been examined (Hayes *et al.* 1999, p.9).

3.2.2 Different Types of Audits

There are usually three types of audits (Hayes *et al.* 1999, pp.11-12):

1. Operational audit
2. Compliance audit
3. Financial statement audit

In an *operational audit*, the purpose is to evaluate the efficiency and effectiveness of a business entity's operating procedures. After the completion of an operational audit a recommendation is often provided to management. In this sense, the operational audit is more of a management consulting function (Hayes *et al.* 1999, p.11).

In a *compliance audit*, the purpose is to determine if the business entity is following procedures or rules set by a higher authority. For example, in a private company, a compliance audit could be to determine whether accounting personnel are following the procedures set by the company controller (Hayes *et al.* 1999, p.12).

In a *financial statement audit*, the purpose is to evaluate if the financial statements are conducted in accordance with specific criteria, e.g. general accepted accounting principles and show a true and fair view or present fairly. The assumption underlying an audit of financial statements is that they will be used by the users previously identified in Section 3.1.1.1.

3.2.3 The Audit Process Model

There are many different audit process models available from various organisation and standard setting bodies. However, the fundamental idea in these models is very similar. The audit process models often consist of four different stages or phases. The explicit content in the stages or phases may differ to some extent between the models, but the overall content and purpose is the same.

As mentioned above the audit process can be broken down into four phases as seen in Figure 2:

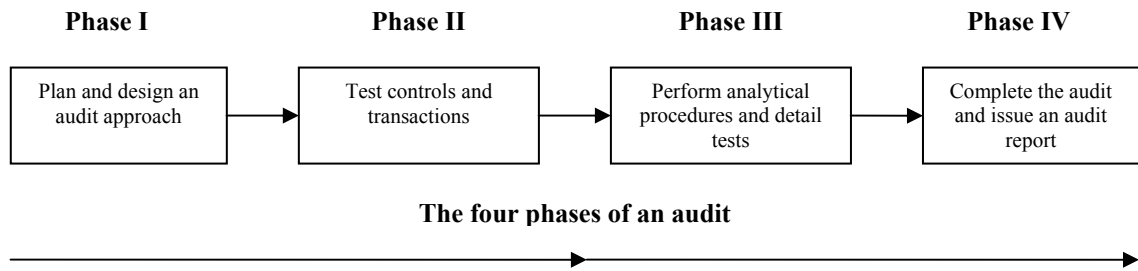


Figure 2 – The four phases of an audit (modified)
Source: Arens and Loebbecke 1991, p.156.

3.2.3.1 Phase I – Plan and Design an Audit Approach

Figure 3 presents the six major parts of audit planning: preplanning, obtaining background information about the client, obtaining information about the client’s legal obligations, assessing materiality and risk, understanding the internal control structure and assessing control risk and developing an overall audit plan and audit program.

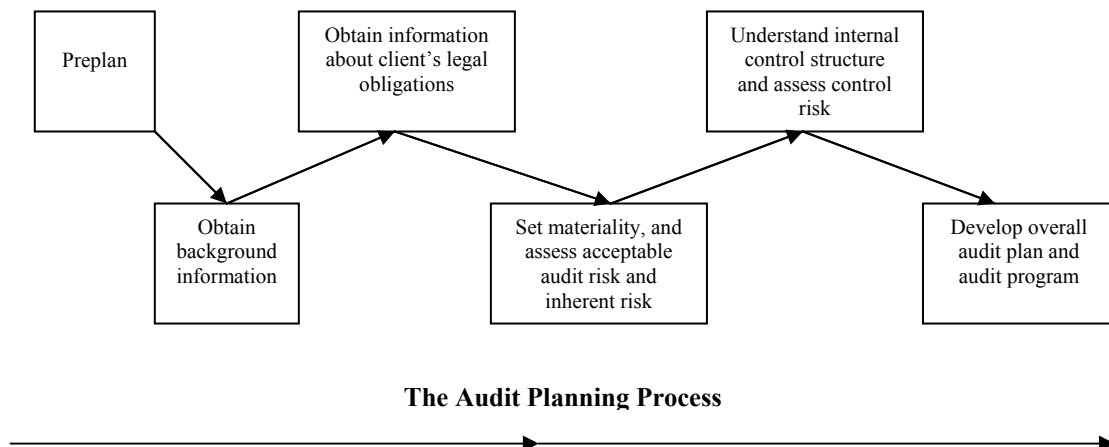


Figure 3 – The auditing planning process (modified)
Source: Arens and Loebbecke 1991, p.205.

Preplanning the Audit

According to Föreningen Auktoriserade Revisorer (FAR), who is the publishing authority of Swedish GAAP, the preplanning often takes place in the early stages of the audit. Preplanning involves whether to accept a new client or continue doing the audit for an existing client. Before accepting a new client, the qualified auditor firm has to determine the acceptability of the client by evaluating its financial stability, the perception of the business community and its relationship with its previous qualified auditor firm (Föreningen Auktoriserade Revisorer 2003, p.276). It is very important for a qualified auditor firm to audit the right clients as the firm’s legal and professional reputation is at stake. A client with no integrity will put the qualified auditor firm’s reputation at risk and hence the firm has to reduce such risk by evaluating the clients.

Furthermore, qualified auditor firms also have to annually evaluate existing clients to see if there are reasons not to continue an audit (Haley *et al.* 1999, pp.15-16).

Obtaining Background Information

In order for a qualified auditor firm to conduct a valid audit of a company, the firm must have an understanding of the client's business and industry. According to IFAC's International Standards on Auditing 315 (2003d, p.6), '*Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit...*' This is very important in order to adequately interpret the information obtained in the audit. Background information about the client can be obtained by, for example, discussions with the previous auditor of the client and by discussions with the client's personnel. Furthermore, the AICPA has published industry audit guides, textbooks, and technical magazines available for most industries for the auditor to read (Föreningen Auktoriserade Revisorer 2003, pp.273-274).

Obtaining Information about Client's Legal Obligations

It is important for the auditor to understand the legal obligations that the client has in order to determine whether the financial statements are properly presented and show a true and fair view. A part of the legal obligations is the *corporate charter*, which is the legal document granted by the government or local government that recognizes the business as a legal entity. The auditor has to determine if the business entity is conducting business according to its obligations and that the minimum level of disclosure is obtained. Furthermore, the business entity *bylaws*, which include the rules and procedures by the shareholders, have to be audited to determine, for example, the correct disclosure of shareholders' equity (Haley *et al.* 1999, pp.151-152).

The *corporate minutes* or the official records of the board meetings, have to be evaluated to determine if the financial statements are materially correct, e.g. the correct amount of dividends and the correct amount of compensation to officers. Hence, the examination of the corporate minutes is often significant to the evaluation of the fairness of the financial information (Haley *et al.* 1999, p.152).

An audit also has to be conducted of the *contracts* that the business entity is involved in with external entities, e.g. long-term loans, bonds payable and pension plans. The focus when evaluating contracts should be contracts that affect the financial statements and financial disclosure.

Assessing Materiality and Risk

When conducting an audit, it is the auditor's responsibility to determine whether the financial statements are *materially* misstated. This is important for the audit, as it is impractical and extremely difficult to provide assurances that the financial statements are correct to the nearest unit (Föreningen Auktoriserade Revisorer 2003, p.271). According to IFAC's International Standard on Auditing 320 (2003e, p.264):

The auditor's assessment of materiality helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures.

The definition of risk in terms of auditing is that the auditor accepts some level of uncertainty when conducting the audit. In order to conduct an effective audit, the auditor has to acknowledge that risks exist and must deal with them in an appropriate manner.

According to IFAC's International Standards on Auditing 200 (2003b, p.7):

The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.

There are three types of risks when considering an audit: *inherent risk*, *control risk* and *detection risk*. *Inherent risk* is a measurement of the auditor's assessment of the likelihood that material errors exist in the financial statement before considering the effectiveness of the internal control system. If the auditor concludes that there is a high risk of material errors thus the inherent risk is high. For example, assets that are highly influenced by large changes in demand and technological changes have a high inherent risk (International Federation of Accountants 2003e, pp.270-271).

The *control risk* is a measurement of the auditor's assessment of the likelihood that material errors which exist in the financial statement will not be detected by the internal control system. The level of control risk is dependent on the design and construction of the internal control system and the integrity of management. A certain degree of control risk is always present in an internal control system as they are never 100 percent effective (International Federation of Accountants 2003e, pp.273-277).

The *detection risk* measures the risk that the audit will not detect material errors due to its planning, direction and scope. Inherent and control risk differ from detection risk, as the former two exist independently of the audit. However, they affect the level of audit necessary and therefore the possibility for detecting errors (International Federation of Accountants 2003e, pp.277-278).

Understanding Internal Control and Assessing Control Risk

The purpose of an internal control system is to generate reliable financial information and to safeguard assets and records. It is crucial that the auditor *understand* the client's internal control structure to adequately plan the amount of audit evidence necessary. For example, if a client has a poor internal control system, *control risk* will be high and hence the amount of audit evidence necessary will increase significantly, as the auditor cannot rely on the information provided by the business entity (Föreningen Auktoriserade Revisorer 2003, p.275).

The auditor gains an understanding of the internal control structure by discussions with client personnel, reviewing organization charts and procedure manuals and by observing the client's activities. With this understanding the auditor can assess how effective the internal control system is to detect errors, i.e. *assessing the control risk* (Arens and Loebbecke 1991, p.157). As mentioned before, the assessment of control risk determines the amount of audit evidence necessary and hence this is a very important step in the planning process.

Develop Overall Audit Plan and Audit Program

The information obtained in the first three stages in the planning process is used by the auditor to assess the inherent risk and acceptable audit risk. This information, together with the assessment of materiality and control risk, is used to develop an overall audit plan '*...describing the expected scope and conduct of the audit*' (International Federation of Accountants 2003e, p.251).

Furthermore, according to IFAC's International Standard on Auditing 300 (2003e, p.253) the information obtained in the first three stages is also used to:

...develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan.

3.2.3.2 Phase II – Test Controls and Transactions

In this phase, the auditor performs *test of controls* of the specific control policies and procedures, to obtain evidence in support of the assessed level of control risk in phase I. The auditor tests the effectiveness of the specific control structures to evaluate if the initial assessment of the control risk is valid. This involves, for example, inspecting invoices to determine a specific transaction. This phase will also test the evidence in support of *transactions* to determine the monetary correctness. This is an important part when obtaining evidence to support the amounts in the financial statement (Haley *et al.* 1999, p.258).

3.2.3.3 Phase III – Perform Analytical Procedures and Detail Tests

In this phase, the auditor has to obtain additional evidence to be able to determine if the ending balances and footnotes in the financial statements are presented fairly. The additional evidence is obtained by using two procedures: *analytical procedures* and *test of details of balances*. *Analytical procedures* are those which assess the overall reasonableness of the financial statement, e.g. by comparing current year's stock level to prior year's stock level to assess if the change is reasonable. *Tests of details of balances* are procedures concerned with testing the monetary correctness in the balances in the financial statements. An example of this test for monetary errors in the balances is by communication with the client's debtors to assure that a debt really exists (Arens and Loebbecke 1991, pp.157-158).

Which procedure or mix of procedures to use is dependent on the level of control risk assessed by the auditor. A high level of control risk indicates that there is a high risk that errors are not being detected by the internal control system, and hence the auditor has to rely more on detail tests of balances. Moreover, a low control risk implies a significant reduction in tests of balances and an increase in analytical procedures conducted by the auditor.

3.2.3.4 Phase IV – Complete the Audit and Issue an Audit Report

After the completion of the phases above the auditor must combine all the evidence and information obtained during these procedures, in order to be able to assess the overall fairness of the financial statements. When this is finished the auditor must issue an audit report which will be published together with the client's published financial statements (Arens and Loebbecke 1991, p.158).

In the audit report the auditor expresses his or her opinion concerning if the financial statements give a true and fair view or present fairly. There are different types of opinions which the auditor can express in the audit report. The most common audit opinion is the *standard unqualified opinion auditor's report* which is issued when the

auditor is satisfied that the financial statements give a true and fair view or present fairly in all material aspects (Haley *et al.* 1999, pp.373-376).

There are circumstances which could result in that the auditor cannot express an unqualified opinion about the financial statements, for example, disagreement with management and if the auditor is unable to obtain the information necessary for the audit. This could result in the auditor issuing an audit report containing *a qualified opinion, an adverse opinion or a disclaimer of opinion* (Haley *et al.* p.376).

A *qualified opinion* is issued when, for example, the disagreement with management is not so material for the auditor to issue an *adverse opinion* or *disclaimer of opinion*. The qualified opinion implies that the financial statements are presented as fairly as possible except, for example, the effects of the matter concerning the disagreement with management (Haley *et al.* 1999, pp.376-377).

When the effect of the disagreement is so *material* and *pervasive* the auditor should issue an *adverse of opinion*. This means that the effect of the disagreement is so important that a qualification would not be enough and it would be misleading only to disclose the financial statements (Haley *et al.* 1999, p.378).

When the possible effect of not obtaining the information necessary for the audit is so *material* and *pervasive*, that the auditor has not been able to obtain sufficient evidence to express an opinion about the financial statements, the audit report will contain *a disclaimer of opinion* (Haley *et al.* 1999, p.378).

Furthermore, as all financial statements are prepared under the assumption of *going concern*, which means that the business entity is viewed as continuing its operation for a foreseeable future, the auditor also has to express his or her opinion in the audit report regarding if the *going concern* assumptions has been met i.e., the business entity will continue its operation for a foreseeable future with no intention or necessity of liquidation (Haley *et al.* 1999, pp. 380-382).

3.2.4 Due Diligence

A commercial venture must be very carefully evaluated in all aspects before the decision to execute, for example, the merger, acquisition, or takeover, is taken. This thorough review of an entity is called due diligence. A due diligence often include, apart from the features of a normal audit, also a more thorough analysis of legal and technical matters (Ernst and Young 2003)

3.3 The Accounting System in the Former Soviet Union

3.3.1 The Planning Structure of the Former Soviet Union

The accounting system in the former Soviet Union was basically a method for insuring that the plan set out by the Gosplan – the state planning commission – was being followed. The reports of the accounts were also the fundamental information which next year's plan was based on. The basic governmental structure is illustrated below in Figure 4. The relevance which the administrative structure gives to auditing today will

be analysed later in this thesis. However, the overall structure of the government has influenced the accounting and management behaviour and thus it is important to briefly describe the structure in the former Soviet Union.

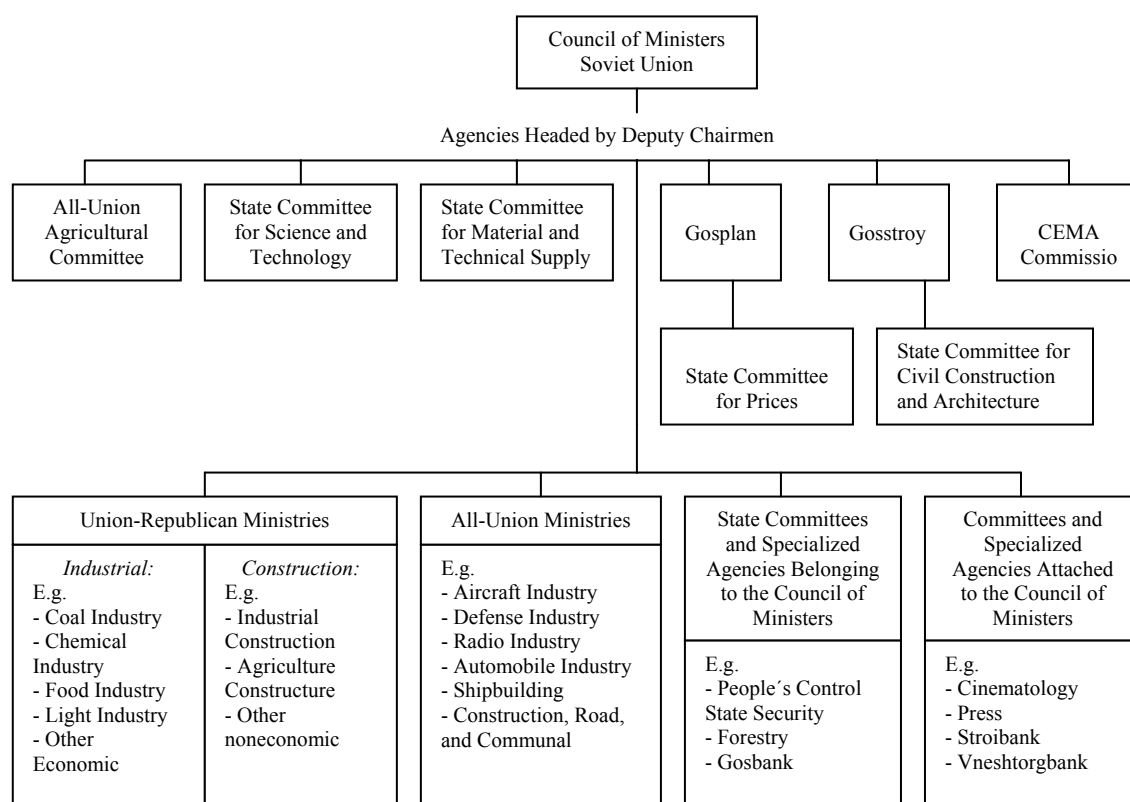


Figure 4 – Central governmental structure of the former Soviet Union: February 1967 (modified)
Source: Horwitz 1970, p.4.

The figure above describes the fundamentals of the former Soviet Union administrative system. It has been changed through reforms on numerous occasions, but the basics are the same and the reforms have no significant influence on this study. As illustrated in the figure above, all industries reports to the same user, namely the Council of Ministers in the former Soviet Union. There are three types of accounting that were used during the former Soviet era to control the national economy (Krylov 1979, pp.66-67), and these will be explained in section 3.3.2.2.

3.3.2 Accounting in Theory and Structure in the Former Soviet Union

3.3.2.1 The Features of Accounting Practice in the Former Soviet Union

The accounting regulations in the former Soviet Union were completely and compulsorily uniform by law. This included a uniform plan of accounts and uniform basic accounting principles. Some of the main attributes of the rigid uniformity are as follow (Jaruga 1996, p.15):

- Accounting records, names and contents
- Definition of accounting terms

- Historical cost valuation
- Cash budgetary accounting
- Incomplete accrual accounting (i.e. no matching of revenues and costs to the relevant period)
- Conservatism in valuating stocks
- Minimum value in capitalised fixed assets (revaluation of fixed assets only took place at lengthy intervals, 15-20 years)
- A set of rules for deferred costs and reserves
- Content, format and frequency of financial statements

As can be seen in the attributes which existed in the accounting system in the former Soviet Union, there is no market value present in any of the accounting principles. However, as the strict and rigid uniformity was compulsory for all companies in the former Soviet Union, the harmonisation within the Soviet block was complete.

3.3.2.2 The Different Accounting Systems in the Former Soviet Union

Statistical accounting, in some textbooks referred to as financial reporting, encompasses – at least theoretically – the whole economy. The statistical accounting was the main information on which the Gosplan based all their decisions regarding the national plan. The higher statistical organisations only received the data as aggregated information, and hence it was impossible to analyse one entity’s performance or even an industry. The statistical accounts were concerned with matters such as the average derivation of out-put per worker, index of growth and related calculations (Horwitz 1970, p.10). The financial reporting of which the statistical accounting was a subject, serves the following purposes: (1) Macro economic control and statistics for the Central Statistic Office; (2) Finance policies and control by the Ministry of Finance; (3) Control by national banks; and (4) Control by supervisory state agencies (Jaruga 1996, p.16). Even if these different purposes may suggest that the financial reports had numerous users, they are all part of the state and serve to fulfil and renew the plan. Therefore the information was relevant in the context of the plan and produced to serve the state and not to base business decisions upon.

The *bookkeeping account* or monetary account monitors the monetary-material values in the economy (Krylov 1979, pp.66-67). This was the accounting which would be equivalent to the traditional Western way of accounting and was the basis for a ‘balance sheet’. Among the fixed assets accounted for in the balance sheet in the former Soviet Union were for example equipment, machinery and buildings. These were all valued at historical cost, but not an historical cost which represents market value at the time of acquisition. Rather, it was an administrative price based on the costs of the enterprise that produced the asset with adjustments by central planners to take certain budgetary or planning priorities into concern (Young 1999, p.162). However, land and land rights were not represented in the balance sheet as this was against the communist ideology.

The most obvious difference among current assets between an enterprise in the former Soviet Union and in, for example, the UK, was the way in which cash was treated. The money, even if it belonged to the firm, could not be disposed of freely. Most of the money was in the Gosbank – the state bank – in non-interest accounts. Money in one account, for example, maintenance, could not be transferred to another sub account, for example investment or worker bonuses. Therefore, the traditional Western way of

‘liquidity’ was not relevant (Young 1999, p.162). Where money was spent was restricted by the overall state plan and the sub plans in the national economy.

The financial data was also summarised in a second report which focused on the result of the year and roughly suggests an equivalent of a profit and loss account. The main differences were that in the former Soviet Union, profits were measured on a different basis. Some costs such as bonuses and capital charges were not considered as costs but as profit allocations. The allocation of profits in an entity in the former Soviet Union is illustrated in Figure 5 below.

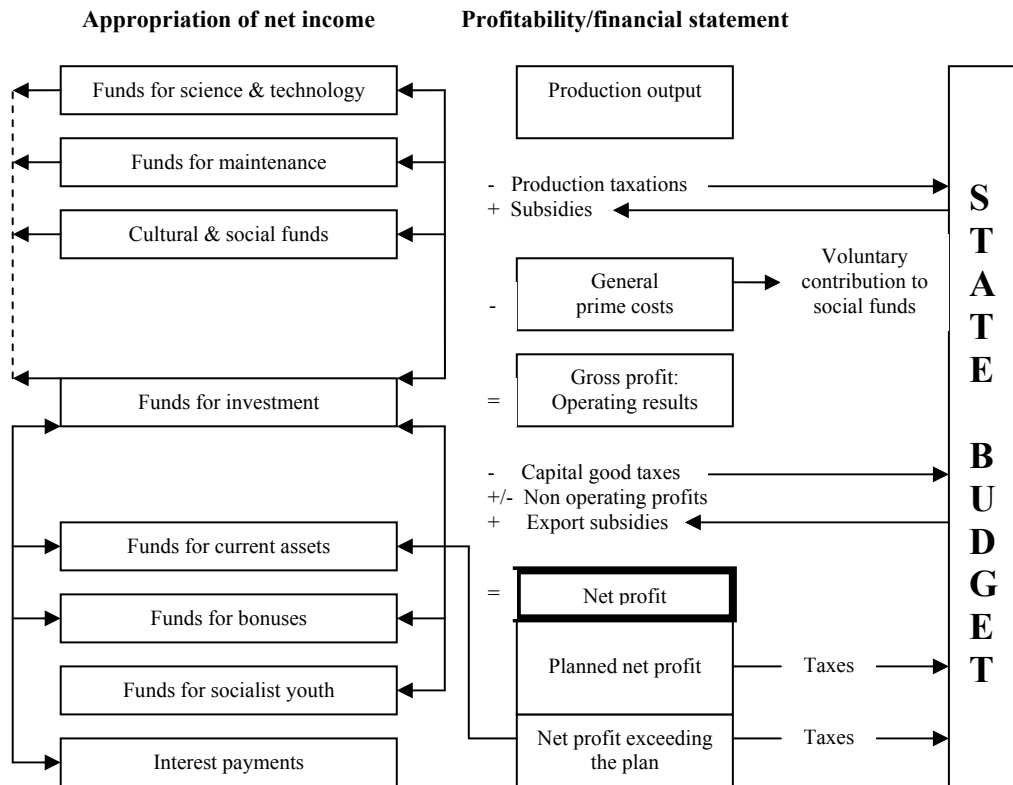


Figure 5 – Distribution of enterprise profits under the GDR planning system (modified)
Source: Young 1999, p.165.

As shown in Figure 5, the entities had planned profits which constituted their contribution to the ‘plan’. Some of the profit may come back to the firm in the form of funds in various forms as means to finance financial activities. If the firm was not generating any profits, the state would decide the budgetary support it was going to receive in order to break even or to reduce the losses. The state also decided the selling prices and prices of raw materials and wages. This bureaucracy further complicated the notion of profits and lessened the managerial efficiency to support and manage the firm. A firm that would produce excess profits could rarely sustain it for a longer period. The planning bureaucracy could reduce the allocations from the state budget to the company; change prices to the company’s disadvantage; or increase the planned profits. This was well known by the management, who through this system had an incentive to not exceed the set profit by too much which would increase their working load and decrease the funds going into the firm. Even persistent losses were generally of little risk to the management in terms of penalties or sanctions (Young 1999, pp.164-166).

The third accounting system was the *operational accounting* which was intended to direct all the managers in the former Soviet system in accordance with the plan (Krylov 1979, p.67). The operational account was not, however, a valuation on managerial performance as it would be in the West. It was rather an accounting system which focused on number of units produced in tons, meters, volume or whatever the measurement was for the particular product according to the plan. If these measurements were fulfilled then the management had succeeded. If the enterprise was, according to the plan, to produce 10 tons of forks they could theoretically produce one giant fork of 10 tons and complete the plan. If the plan on the other hand was to produce 100 000 units of forks, an enterprise could produce 100 000 units of extremely small forks and complete the plan and have raw material over to sell on the black market.

3.3.3 The Accounting Profession and Audit in the Former Soviet Union

As the chief accountant's role basically was to secure and protect socialist property, he or she was appointed by a higher authority than the management of the enterprise. The chief accountant who was the head of the accounting and financial department in a firm focused mainly on financial control over the enterprise's activities on behalf of the Ministry of Finance. The financial control served to oversee the financial discipline of the state owned enterprise which resulted in regulations being enforced which limited managerial decision making (Jaruga 1996, p.20). As the whole system of the planned economy was to consider itself as one big entity, the accountant's role was to be viewed as an internal auditor.

The role of the accountant has, however, changed since the reform of 1966. After the reform the accountant should also provide the management of the enterprise with the necessary financial information needed for decision making. This was a logical step as the reform was to, if just slightly, move away from a centralised system towards a decentralised system. The accountant was still, however, a 'government controller' and had to inform the government if there was an excess of material or profits in the enterprise (Horwitz 1970, p.9).

Furthermore, the accountants in the former Soviet block were not encouraged to use their professional judgement in assessing a company's performance and its value. This was something which was very different from the West where it was the accountant's duty to use his or her judgement when assessing a firm. The auditing was basically to ensure that the plan was being followed and to report to the authorities if the set profits were in excess of the plan or if any other diversity had occurred. As mentioned previously, market values were not in use – indeed, it could be argued that they did not exist – and the director was being assessed by the fulfilment of the plan as also described previously. Furthermore, the accounting system was thoroughly controlled by rigid laws and restrictions and the sole owner of the enterprise was the state. Hence there was no need – according to the Soviet Socialist ideology – to have an external auditor equivalent to that in the West.

3.3.4 Management in the Former Soviet Union

The term 'Management Sovieticus' refers to the management in the former Soviet Union where a socialist economic system was created on the basis of socialist ideology.

The economic environment, i.e. the ideology and way of thinking of the planned economy, proved a strong influential characteristic in the creation of the Management Sovieticus. The effects that the economic milieu had on the management practice were in their totality powerful enough to break the thinking on individual level. This has resulted in that the fixed features of the management style in the former Soviet Union – the ‘management according to the plan’ – which has not changed along with the external environment (Liuhto 1993, pp.8 -9). The ultimate purpose of the Management Sovieticus was to create uniform managerial behaviour within the Socialist bloc, a behaviour which was to be controlled from the centre of the former Soviet Union.

Management Sovieticus was not only a feature in the former Soviet Union, it also spread through the entire Eastern bloc. The transition from a planned to a market economy, which dismantled the iron curtain, has resulted in that the inheritors of Management Sovieticus have been able to change their management behaviour freely according to their own needs (Liuhto 1993, p.9).

The main disadvantages of Management Sovieticus can be summarised as follow (Liuhto 1993, pp.9-17):

- Political maturity as basis for recruiting managers.
- Administrative PR-management; the maintaining of confidential relations with the planning organs.
- Bureaucratic-authoritarian manager dictatorship, which is manifested in the reflections of a command system within the enterprise.
- Wasting and hoarding of factors of production. Material, labour, money and time were wasted by means of, for example, a great number of workers involved in the execution of a simple task, and also natural resources were brutally abused.
- Ignoring the product’s usefulness and quality. The companies in the former Soviet Union focused on how they could create the optimum way of operating for themselves from the deliveries from the government which usually were made at the expense of usefulness and/or quality of the product.
- Massive feudalistic business entities, which decreased the employee’s opportunities to have any influence on the management of the business. The size of the companies also added to the dictatorship of the manager – the feudal lord. These large business entities were also obliged to include social functions among their activities. For instance, they were supposed to provide their personnel with accommodation, education and hospitals.
- Organisational misuse was a common phenomenon by both personnel and management in the planned economy. Stealing from the government, for example, was not usually considered immoral. Because it was a common phenomenon it became an accepted and integrated part of the business culture.
- Withholding of information was another common irrationality in the former Soviet enterprises (Lawrence and Vladchoutsicos 1990 cited Liuhto 1993, p.16). In the planned system, information was regarded as means of gaining power and was jealously looked upon (Graham, Evenko and Rajan 1992 cited Liuhto 1993, p.16).

- Ignoring innovation; more important than innovation was the maintaining of status quo – the set goals by the planning authorities – which resulted in increasing bureaucracy and the retaining of old customs.
- Lack of strategic management; the companies had very little or nothing to do with the demand in the market, it was supposed to act as an executor of the plans set out by the planning organs. Mintzberg (1992 cited Liuhto 1993, p.17) argues that Eastern Europe or the former Soviet Union did not lack planning; however, it had no strategy or strategic vision.

3.4 The Economics of Transition

The economics of transition from one fundamental economic framework to another is not a well trodden path. One of the most common out puts of the transition, besides of course the change of economic philosophy, is inflation or even hyperinflation (Kizilyalli 1998, p. 10). Kizilyalli (1998) further argues that the transition in Eastern Europe and the former Soviet Union has resulted in not only inflation but also increased unemployment and declining out put.

The transition economies are due to many uncertainties hard to make any prognoses about concerning their future developments. Rollo and Stern (1992 cited Kizilyalli 1998, p.70) note that it is impossible to forecast longer predictions regarding these economies. They based their statement on identified problems which are to be regarded as generalised complications which are very likely to arise in any transition economy:

- The massive scale of changes which are to be undertaken,
- The possibility of serious mistakes regarding the route from plan to market economy,
- The lack of experience in the region and of the region, and
- The serious lack of reliable data.

Lavigne (1999, p.165) argues that the privatisation of state owned enterprises, which is crucial to engage in a transition, is not as easy as it may seem. Privatisation can not be seen as achieved once the ownership has been moved from the state in to ‘private hands’. The former Soviet state enterprises are still burden by old debts, obsolete equipment, management who are trained in the ‘Management Sovieticus’ spirit, and often very wrong industry specialisation. A further problem is that the new property rights are seldom clearly defined. These are problems that have to be solved before one can speak of a ‘standard’ or normal private market economy. It is also a common problem that one assumes that when a new system has been implemented, the people in the region will change accordingly. However, the people will still possess the old habits and mentality to which they are accustomed. This problem or characteristic of human behaviour has to be taken into consideration and it must be recognised that the economic progress is dependant on the behaviour of the people (Kizilyalli 1998, p.56).

In the former Soviet Union, and in most other Socialist economies as well for that matter, an alternative economy was developed besides the official one. This economy is often referred to as Shadow economy (Lavigne 1999, p.62). This shadow economy is, according to Lavigne (1999, pp.9-10) one of the most harmful legacies of the past, which has heavily constrained the transition and the emerging of a new economy.

Subsequently, many activities which involves hoarding, stealing of property for example, are referred to as shadow activities.

3.5 Summary of Theoretical Framework

It is the conceptual framework for financial reporting that sets out the concepts that underlie the preparation and presentation of financial statements. The objectives of financial reporting are to provide a picture of the overall financial statements of the business entity. It is also important that financial reporting provide information useful to those whom it is prepared. Thus in order to disclose information useful for the user one has to know who the user is, the purpose of the information and how much information should be disclosed?

Some companies are required to have an audit and some companies choose to have an audit to satisfy lender requirements, tax requirements or investor requirements. An auditor's main duty is to determine whether the recorded information in the financial statements give a true and fair view or is presented fairly in all material aspects. When conducting an audit the process includes four stages or phases: plan and design an audit approach, test controls and transactions, perform analytical procedures and detail and finally completing the audit and issue an audit report.

The accounting system in former Soviet Union was basically a method for insuring that the plan set out by the Gosplan – the state planning commission – was being followed. The accounting regulations in the former Soviet Union were completely and compulsorily uniform by law. This included a uniform plan of accounts and uniform basic accounting principles. The accountant's role was to secure and protect social property for the state and the chief accountant in an enterprise focused upon mainly financial control over the enterprise's activities on behalf of the Ministry of Finance.

Moreover, the economic problems which are likely to be present in a transition economy may also have an impact on accounting and auditing. These problems could involve inflation and other economic and financial problems relating to the massive scale of changes.

Having presented this theoretical framework or fundamental accounting principles, the purpose and methodology of auditing, and an introduction to the accounting system in the former Soviet Union, in the following chapter we turn next to the interviews we conducted during the course of the research. In these interviews, which constitute the primary research of the thesis, we seek to develop a practical understanding of these areas of interest, leading in subsequent chapters to some generalised conclusions.

4. EMPIRICAL STUDY

This chapter will present the interviews that were carried out in the empirical study. In this chapter we are summarising what was said during the interviews and occasionally we are using direct quotations. For each of the first three interviews, where the interviewees are all current or former accounting and auditing professionals, we present their responses to the questions in the same four categories to enable the reader to more easily make comparisons. These four categories are:

- General Accounting Problems in the Former Soviet Union
- General Accounting Risks in a Transition Economy
- Auditing Risks in a Transition Economy
- Solutions to the Accounting and Auditing Problems

In the fourth and last interview, conducted with a management consultant and academic, the focus of the interview is necessarily changed, and the section headings for the fourth interview reflect the interviewee's different perspective. All interviews were carried out in Swedish. The interviews will be presented as close to the original interviews as possible. Some slight differences may occur due to the translation from Swedish to English. The interview guide used in the interviews can be found in Appendix 1.

4.1 Interview One

The interviewee is an accountant who is a native of Latvia. The interviewee moved to Sweden in the 1950's and has worked for many years as an accountant in a leading accounting firm both in Stockholm and Latvia. The interviewee's relevant experience for this thesis is accounting in Latvia. The interviewee was sent to Latvia by the Stockholm office to assist in the change-over in 1990. In Latvia the interviewee held the position of managing director for the same accounting firm's local office. The interviewee retired in the year 2001.

4.1.1 General Accounting Problems in the Former Soviet Union

According to the interviewee, the old system performed well in matters concerning details and quantities and such things that could be measured in units, for example, kilograms. However, the old system was not able to put a price on the things it measured. The greatest fundamental disadvantage with the old system was its inability to establish a company's profitability for the simple reason that the information did not exist. The old system was also very detailed regarding the accounting procedures. Everything that was to be accounted for, and the exact way of accounting, was regulated. This was necessary in order that Moscow could implement the information into the overall plan.

This detailed procedure of accounting had an impact on the profitability of the company. It had a negative effect on the productivity of the companies because they had to put so many resources into the accounting. The accounting focused on details but had little application in reality. All resources were controlled by Moscow and everything

had to be accounted for in detail. Companies even had to account for waste so that nothing could be stolen or used outside of the firm in a way which Moscow had not expressly permitted. If a company has to pay attention to all these details it cannot possibly survive as an effective enterprise. There were, however, ways to work around all these details. Many of the methods were inefficient and they have, quite possibly, only survived because people were accustomed to them.

4.1.2 General Accounting Risks in Transition Economies

The interviewee states it is difficult to pinpoint exactly which accounting risks are explicit for the transition economies. The big question an accountant or an auditor has to ask him or herself when it comes to accounting, auditing and taxation is whether or not the people involved within the organisations have understood the new rules and procedures. This was the main problem in the Latvian case.

The chief accountants within the firm had the old system in the back of their head and when they applied the new rules, mistakes happened.

The problem was that the way of thinking was wrong, although it was not deliberate. They simply had no experience of the new system that the implementation demanded. The interviewee further states that there was no cheating or lack of understanding in Latvia any more than in Western countries.

All the big accounting firms were in Latvia at the beginning of the 1990's to help with the implementation of the new system. The main reason that the big accounting firms got involved in the implementation was to ensure that the new system was used in the correct way. The main problem was making people understand the new system and everything that came with it. The implementation was carried out successively and as time progressed, the domestic accountants learned the new system. The interviewee further explains that it was not only the new rules; they had to learn new information technology systems, new techniques in both production and accounting and financial reporting.

4.1.3 Auditing Risks in Transition Economies

According to the interviewee, the main problem regarding auditing in Latvia, as a result of the transition, is to know whether or not the companies had fully understood the new rules. There could be many fundamental errors concerning, for example, depreciation and other accounting techniques with which they were not familiar. Another problem was that the managers' role had changed and some did not accept the new system.

During the Soviet era, there were two persons in an enterprise who were responsible for accounting. It was the chief accountant and the equivalent of a managing director. After the new rules had been implemented the persons in charge of accounting were no longer important people in the same sense as they had been before. The fact that they so suddenly had lost their prestigious role was not appreciated. In the old system, it was the role of the chief accountant and the managing director to sign the equivalent of a financial report. After the implementation of the new system it was only the managing director.

In the old Soviet style system it was the chief accountant who should report to the ministry which in turn reported to Moscow. It was of great importance that all this was carried out properly since the enterprise was given resources which were based on the report from Moscow.

Furthermore, the trust between the chief accountant and the managing director was – as experienced by the interviewee – exceedingly high during the Soviet era. However, after the implementation of the new system, the managing director of a firm did not know what was going on. Sometimes the chief accountant explained something in one way when it was supposed to be the other way. The chief accountant had no authority and in the new system the managing director was in charge. However, the managing director was in charge over something that sometimes was fundamentally wrong.

The new system also resulted in something which could be viewed as a lack of trust among all parties involved. Everything that *had been* accounted for was double checked over and over again. However, everything *was not* accounted for which, from an auditing point of view, is very hard to check. But, as mentioned before, the internal accountants paid great attention to following rules, regulations and instructions. On the other hand, there were ways of operating outside the system for personal benefits.

In the interviewee's opinion, the legacies from the Soviet era are present but often hard to identify. The legacies have changed over time, and in the beginning it was a 'fight' between the enterprises and the taxation office. The taxation office was still thinking in accordance with the old system; everything should be exact with no deviation, not even a millimetre. If you had missed something there was no opportunity to fix it, you simply had to pay a penalty. It was a bit unpleasant in the beginning. The atmosphere was tense and threatening when the taxation authorities were about to look in the 'books'.

The GAAP which Latvia implemented in the new system was IASB's standards and it was already in use in 1992-93. The IAS use market prices and values similar to that of US GAAP which proved to be a problem at the start of the transition. There was no relevant information on which the market value on properties and other assets could be based.

We were asked, for example, if properties could be valued on the basis of the old system which had valued properties in accordance with something which could be referred to as taxation value. There was nothing else to choose as a substitute for market value.

There were so few transactions that had been recorded, so even if something had been sold, it was difficult – or even impossible – to determine who had bought what from whom and under what circumstances. Much information was hidden in the secrecy which existed among companies. According to the 'Soviet way of thinking' even the information regarding the employees of an enterprise could be a secret. The term 'trade secrets' was misunderstood or misinterpreted and was used to an extreme extent; everything could be argued to be a trade secret, especially information that you did not want to show. This secrecy had a negative effect on the trustworthiness between the external accountant or auditor and the company. This was more obvious at the beginning of the transition and, according to the interviewee, it is not a major problem to day. This problem was resolved already five years ago.

We [the external auditors from the West] audited foreign daughter companies according to the rules of the country in which the mother company had its main office. This meant that we had strict rules to follow regarding how this auditing was carried out. All companies had an interest in giving out all necessary information so that we could write a complete and fair report. They – the companies – did not try to hide information or make mistakes on purpose. But then, of course, some involuntary mistakes will happen.

The main problem regarding auditing in a transition economy is – as explained before – to assure oneself that the companies' accounting staff knew what they were doing. As far as the interviewee is aware, this risk or problem is still the main problem today. The problem is dealt with by means of checking with the accounting staff to see if they know what they are doing.

I would have asked; do you know that it is like this? How do you think this should be dealt with? I would simply have checked the theoretical knowledge among the accounting staff.

The problems or risks are not to be considered as industry specific ones, but rather as general problems which occurred everywhere.

The lack of a real market economy prior to the transition (which created a black market or shadow activities) has not resulted in any auditing problems.

We did not notice this much at all. But put it like this, in the beginning of the 1990's, it was very important to have contacts with suppliers in order to get deliveries. Everything that was delivered was insufficient, there was not enough raw material or other inputs. And because of this it was not the price that determined whether or not something could be delivered, it was whether or not you had contacts. And often it was contacts outside the former Soviet Union that were needed because there was a lack of everything in the former Soviet Union.

The interviewee does, however, state that in her own experience there have been no problems with these types of black markets or some equivalent; she does admit that they may exist.

With reference to inherent, control and detection risks, the interviewee claims that the control risk is the main problem. The internal accounting systems were often implemented by the mother company. And in some cases there were double sets of accounting systems because of the monthly reports. These monthly reports should go into one system and at the same time you had to use another system which existed in Latvia. This double bookkeeping does not refer to one legal and one illegal; one system was used to report to the mother company and one according to the legal requirements in Latvia. It is also this risk which needs the most attention and when questioned about the source of this problem, the interviewee refers to previous answers; the lack of theoretical and practical knowledge.

4.1.4 Solutions to the Accounting and Auditing Problems

The interviewee stated that in many cases there were uncertainties regarding how something should be dealt with. As an auditor you could not be convinced that the accounting staff of the enterprise knew exactly what they were doing. This meant that

‘detail tests’ were a necessary tool. One had to be particular on details and control and double check everything. This was not as hard or expensive in Latvia because salaries were lower and you could put four assistants on a job like this which would have been very expensive in most other countries. This additional cost was something that the interviewee and her colleagues were prepared to take but it was hard to convince the companies that such these detail tests were necessary. There were no theoretical models which stated that you had to do this.

To really understand what had happened and what had been done we had to go in and look at details, for example, thoroughly check inventories, which takes a lot of time and often feels like an unsatisfactory duty. However, these problems come from the lack of experience as mentioned before.

The interviewee states that while she was born in Latvia, she does not believe this fact influenced the answers to the interview questions.

Even though I was born in Latvia I do think that I have a ‘Swedish’ view of things. I have the same experience as most Swedish accountants; I have worked as an accountant in Stockholm for many years.

The interviewee says, however, that the one main difference between herself and her colleagues in Sweden is that she speaks Latvian. This mean that the interviewee, unlike most of her Western colleagues, could talk to the people involved in their own language. Back then, in the early 90’s the Latvians did not speak English very well.

The accounting staff and other persons involved could explain things easier in Latvian than they could in English. Nowadays most of the younger people speak English, before they had no other language apart from Latvian, maybe, Russian.

4.2 Interview Two

The interviewee’s country of origin is Sweden and he works for one of the main accounting firms. The interviewee has worked as an accountant, for the same accounting firm, in many different countries, for example, the Ukraine, Germany and Romania. He is currently working in Romania and prior to that he was working in the Ukraine. The interviewee’s comments will principally be about his Romanian experience with reference to, for example, the Ukraine.

4.2.1 General Accounting Problems in the Former Soviet Union

According to the interviewee, generally speaking one could say that in the old Soviet system nobody really checked the amount that had been accounted for. It was more important that everybody had something to do. The financial data was not really looked at and neither were the results of the companies. The targets which were often set at production level and other fixed measures were more important than the result. The goal was often to reach a certain quota regarding quantity and to employ as many people as possible.

The main difference with regards to accounting and financial reporting is that the personnel in charge of accounting and finance were not used to analysing figures and

numbers. They consider the figures as a given output when you had registered a transaction. This was all part of a mechanical process. The analysis is not their strong point but it is starting to change as new, younger professionals are coming from the universities and gaining experience. This will give the profession a new way of thinking which the older generation lacks because it was simply not included in the old system.

4.2.2 General Accounting Risks in Transition Economies

One principal problem is the law and the way it is written. The taxation laws are very general in nature and they are so for a reason. The taxation officers seek an opportunity to collect fines and more tax for non-compliance with rules and regulations. The ambiguous taxation laws have had a negative influence on foreign investors. The taxation officers even get a commission on taxes and fines they gather, so obviously they will interpret the laws in order to get the commission. This is, however, about to change now. In Romania the laws are changing as a result of their trying to get accepted into the EU in 2007.

It [auditing] is easier for countries closer to Scandinavia such as the Baltic States. It is also easier to change laws and other regulations in a country which is smaller. Corruption exists in all former Soviet Union or other communist states. However, the further East you go, the more apparent is the corruption. The Baltic States are closer to Scandinavia and have not been as troubled by war and political intrigues from a historical point of view as Romania and Bulgaria, for example. Romania is probably one of the most corrupt countries in Europe. However, sometimes one has to ask oneself what is corruption? You have to look at the development of salaries and income. The largest part of the governmental administration is very poorly paid and they need all the extra money they can get.

Another main difference is that in Sweden and the rest of Western Europe it is not very often that the auditors' report is qualified. If it is not unqualified you will start to look for mistakes and people will get worried. Here, in the transition economies, it is likely that 50 per cent of all auditors' reports are qualified or even to have a 'disclaimer of opinion' or 'adverse opinion' which is very rare in the West. For obvious reasons this is not accepted by many foreign mother companies who demand actions to be taken in order to correct the accounts. However, quite a few entities do not care whether or not the auditors' report is qualified. The mentality is sometimes that a qualified auditors' report is something normal in the current state of affairs. However, sometimes the reason why the company may not care is that the subsidiary is not materially large enough in this part of the world – the former Eastern Europe – from the perspective of the entire group of companies. So, the group might not care if a small subsidiary in, for example, Romania, has a qualified auditors' report.

The interviewee has not, however, had any significant problems with shadow activities. It [the problems of shadow activities] does exist but it was mainly in the old state owned entities and now in the private sector it has not been a problem. In the beginning of the transition, shadow activities were a problem because they were a part of their lives, and they needed it to survive, but it is mostly gone now. This has been resolved by new laws which give the managers more responsibilities. For example, the manager in charge of stocks or inventories is also responsible for each product; he or she is personally liable to pay for everything missing.

4.2.3 Auditing Risks in Transition Economies

When it comes to properties, there have been, and still are some problems in determining their market value. Market value did not exist in the communist regime and it is hard to obtain relevant information regarding ownership and transactions. Furthermore, Romania had super inflation in the middle of the 1990's from which it is now recovering. Today the inflation is about 15 per cent, whereas, in 1998 – when the interviewee arrived in Romania – inflation was 100 per cent. This was an additional problem for the accountants who had to make adjustments for inflation in the financial reports, especially reports to foreign mother companies and companies who wanted their annual reports to be in accordance with IFRS/IAS. IASB standards are the general standards for companies who want to take a loan from a bank or anywhere else. It is not, however, stated in Romanian law that public limited companies must follow IASB standards.

The interviewee has experience of problems regarding the local accounting firms. The problem here is mainly that any accounting or auditing they would do is not in concordance with the way that it is normally done.

They carry out certain procedures and then they put a nice big stamp on a piece of paper. These stamps carry a lot of authority, a signature has no meaning; you need a stamp. Even if proper auditing has not been done, you want the stamp which says it is okay. These local accounting firms are doing more harm than good.

Another problem that occurs in the transition economies is that they are used to doing their accounts on the basis of cash payments, i.e. with no matching of costs or revenues. You could say that a Romanian profit and loss account was more like a cash flow statement. This has been a problem when implementing the accrual concept, one of the four main principles in Western accounting.

In the former Soviet Union, they had no tradition of accruals; you put the amount in to the 'profit and loss account' when the bill had come. This has been a critical problem which we have to consider. It is just different principles that have been used in practice.

Risks related to auditing can be put into three categories. Incidentally, the interviewee points out that these risks are only categorical in theory. He – the interviewee – would never think in terms of inherent, control, and detection risks in practice.

Inherent risks

This is the business itself so to speak. In a transition economy you do not recognise any other problems than in a Western company.

Control risks

Here there are major differences. In a transition economy you can not trust the internal control. The internal controls are not sophisticated enough and do not detect any problems or mistakes.

Detection risks

According to interviewee, detail testing is necessary to detect problems or mistakes. This means that there is little risk that the accountant or auditor will miss anything.

When you are auditing a company in the former Eastern block you have to be prepared to allocate more time and resources because of the need to carry out detail tests (probably twice as much time as in a Western company). This is more apparent when you are auditing a former state owned company, especially if it has not been subject to auditing prior to the current year. The internal information technology systems in the former state-owned companies are not as developed and it is hard to get the information required. This means that more time and more people are needed to finish the audit.

The interviewee also talked earlier about the problems regarding historical costs on properties in which there has not been a revaluation. This can be very hard to do because in such cases there are many companies who specialise in valuation of properties but it is difficult to determine how trustworthy or serious they are. It is up to the companies to decide if they want a specific firm to revalue their properties. It is also a possibility that there is no market value or historical cost which can be determined at the time.

4.2.4 Solutions to the Accounting and Auditing Problems

According to the interviewee, the lack of internal control in the companies is solved – as mentioned before – with detail tests; back to basics so to speak. This has also been the case in the West following all the scandals, even if not to the same degree. In Sweden we do not take this as seriously as we should. With his experience, based on Anglo-Saxon traditions, the interviewee argues that it is really such traditions that control the development of accounting and financial reporting, and the Anglo-Saxons are more structured than the Swedes. This is not a criticism of Sweden but more of an acknowledgement of differences. In Sweden the auditors do not always have all the evidence and transactions that they need and the checking or valuation of the internal control systems are not taken as seriously as it should all the time. The control system may have been verified even though not all the tests needed to be sure have been carried out.

Shadow activities are not something that are of significant concern. The auditor does a risk-analysis based on the structure of the enterprise and other factors. Normally shadow risks are not something that come up and it is not more of a problem in Romania than anywhere else. However, one problem is whether or not the customer will pay. This can be a problem on occasion because, when it comes to paying your debts, morale is low and it takes a long time to get all debtors to pay. This is a major risk in the transition economies. This becomes apparent when classifying bad debts. In the West you normally recognise a bad debt when the debtor has not paid in three months. In the transition economies, however, a bad debt may not be recognised even if the debtor has not paid after a year. Because people do not pay when they are supposed to, a debt that is a year overdue may still be paid.

Another problem for an inexperienced auditor is the trading with debts and credits, which could be explained as follows. If a company has a debt to an electricity company and then sells something to another company they may cancel the debt to the electricity company with that which the buyer owes them. The electricity company will then have a debt to collect from the third company (the one who bought products from the first company). In the Ukraine, and to a lesser extent in Romania, there is also the problem with double bookkeeping. With this the interviewee does not mean the traditional sense

of double bookkeeping with credit and debit, but rather that some companies would have official accounts and then keep a separate book over everything else, i.e. the transactions which they do not want to show the authorities.

When it comes to the problem of the interviewee being a foreigner, he recognises this and states that there are differences.

People here think differently. It is hard to put your finger on it but they have another way of looking at things. I always seem to get surprised; it is like you cannot follow their way of thinking. They do not go from point A to B direct. They always take a different way which to me seems to be a more complicated way.

This becomes apparent when you look at documents. Instead of writing and concluding the subject on one page, they can write ten pages without getting to the point. It is also this way of thinking that prevails in the universities. People in the transition companies, especially in Romania, have a different way of drawing conclusions.

The differences between a local accountant and a foreigner are not that significant anymore. The big accounting firms recruit new assistants from the universities and train them in the same way they train everyone. However, people in many of the transition countries are less willing to take responsibility. You have to chase them and force them to take on their responsibilities.

The relationship between the management in the companies and the accountant who is doing the auditing can sometimes be troublesome. It takes a longer time to get the relevant information and quite often there are misunderstandings between the 'chief accountant' and the external accountant. It also happens that the company may forget to hand over some important information, and it is not clear whether this is deliberate or not.

In the old system information was power and people who have important information are sometimes not willing to give it away. The interviewee sometimes got the impression that the companies do not fully trust the external accountant's confidentiality. Furthermore, in the former Soviet Union and most of the communist states everything could be considered trade secrets. The mentality of this can still be seen today; some information that should not be classified as trade secrets is recognised as such. The companies are often unwilling to let you talk to anyone else other than the manager in charge. They may be afraid of misunderstandings; the interviewee does not believe it is because they want to hide information. These problems result in the need for great caution when coming to any conclusions.

Sometimes you just don't get the information you need and there is no way to solve it. The result is often that the auditors' report will be qualified.

The main reason for all the qualified auditors' reports is the lack of understanding surrounding accounting principles and indifference to whether they are qualified or not. If you talk about local businesses there are few who care if their auditors' reports are qualified. The situation, however, is likely to change in the near future; the World Bank has acknowledged the problem and wants a change. Also, in Romania they have a new accounting law which is based on IASB's standards; however, there are many differences so there will still be problems.

The interviewee has not noticed any problems regarding his background as an accountant from the West. He is more involved in the planning side of things and makes sure that the accountants that are doing the auditing are doing it right. An important thing is to make sure that the detail tests have been carried out in a satisfactory manner.

A few years ago it was very common to receive inspections from the taxation office. This was an unpopular visit from the managers' perspective and it contributed to the strained relationship between the external accountant and the company.

They [the management] had problems understanding what we were doing in comparison to the taxation officers. They did not see that we were actually on the company's side. This is one reason why it was hard to get information at times.

Furthermore, in general the people of the former Eastern block are very sensitive to criticism. This is another reason why auditing is a sensitive subject because it produces findings that are not necessarily what the managers want them to be.

We have a type of report called 'management letters' which we use on international tasks. In those letters we comment on our findings and also suggest recommendations to improve the situation. This is something they can be very sensitive about. It has, however, been better for the last year or so.

4.3 Interview Three

The interviewee's country of origin is Sweden and he has worked for 20 years as an accountant. The interviewee is working for one of the main accounting firms within the corporate finance recovery department. Apart from pure auditing, the interviewee has mainly been involved in due diligence – mostly in banks – in transition economies such as Lithuania and Russia. Furthermore, the interviewee has also been involved in technical matters such as evaluating the structure and contents of monthly reports.

4.3.1 General Accounting Problems in the Former Soviet Union

When the interviewee arrived in the former Eastern block in 1994, most of the old Soviet system was still very much present. The disadvantage of the old Soviet system which can still be seen today is that all organisations were focusing on reaching a specific target. This target was often a number of units that could be produced or measured in units, for example, kilograms. The accounting procedure in the old system was mainly to summarise numbers, and there were no results to calculate; there was no profit and loss account, only figures which concluded how many units had been produced. Later on in the transition there existed one or two entire generations who only knew this old system. Today everything is brand new and in cases like that you have to start from scratch. This is why you can see managers at high levels, even managing directors who are only 26 or 27 years old.

According to the interviewee, it can be difficult to see any advantages with the old system. However, one thing that the people in the West do not understand is that the transition has a significant effect which is often detrimental to the people in the country. The West is of the opinion that everything is better now under a market economy. There is a difference, however, if, for example, one compares Poland to Russia. In Poland they

started to move toward a market economy much earlier than Russia. Russia has been a communist economy since the collapse of the Tsar regime in 1917. They have never had any market economy and about 90-95 per cent of the population cannot see any advantages with the new system.

I was in Russia for the first time in the early 1980's and you did not see any really poor people back then. Everyone was guaranteed a certain standard and many of the old people do not see any advantages with the market economy.

The interviewee states that this can also be seen in the Baltic States where the domestic communist parties gained many supporters in the early stages of the transition. The interviewee further states that the economy in many of the transition countries is more like a pirate economy than a market economy. *'A non controlled market economy is as bad for the country as a planned economy.'* In the former East Germany (DDR), for example, the inhabitants of the state said that they had no freedom but they received education, work, accommodation and healthcare and this is more than most people have today.

4.3.2 General Accounting Risks in Transition Economies

According to the interviewee, practically all transition economies have changed their old accounting (if you could call it that), to IAS or something similar. Because the old way of accounting was not really accounting as the West would call it, it was more of a way of ensuring that the overall plan was followed and thus there have been many problems. The transition economies went from practically no real way of accounting to IAS without any experience. The old system has not influenced the structure or contents of the new accounting system because they just got rid of the old; they had nothing to build on. This has resulted in – as mentioned before – that the younger generation is taking over almost everything. The ones that are in charge of the financial reporting are those who have grown up in the new system. The older generation still thinks in the old ways.

One typical example in the banking industry in which I have experience of the internal accounting is that they [the older generation] were supposed to visit a number of offices and when this was done they were finished. It did not matter if they had checked what they should or if they had any clue what they were doing as long as they had visited all the offices and put this into their reports. The external accountants do not care a bit about these reports; the only purpose is to occupy the time of the old management.

It is necessary to start from scratch in order to school the people into the new way of thinking. The process is, however, surprisingly fast. The interviewee states that even after only 7-8 years of working in transition economies he can already see an enormous difference in the way of thinking.

4.3.3 Auditing Risks in Transition Economies

The interviewee believes the main risk when it comes to auditing in a transition economy is that there is a big chance of a lack of knowledge, especially among the internal accountants and the risk is that there will be many mistakes, some of which will not be found and corrected. All this was very new for the domestic professionals. The

general auditing risk was, and still is, that the internal accountant does not have the knowledge to prepare the accounts. It was a bit easier for Scandinavians than for the British who had the old colonial attitude, or at least they were perceived as such because they were acting in an intimidating manner.

One problem which is fairly common was the lack of 'going concern'. The interviewee refers to the mafia controlled banks and other banks who did not operate legally. In the Baltic States there were almost 60 to 70 banks of which many were controlled by the Russian mafia. They opened many offices and banks frequently and the interest was about 30-40 per cent. This high interest rate was an incentive for people to give the bank their savings and it was common that the banks then closed down and disappeared with the money, i.e. they robbed them. This was a common problem at the start of the transition and is still considered as a major problem and one which the auditors have to take into consideration.

These problems concerning the 'going concern' of banks and other institutions means that the external auditors have to look very carefully at the organisations balance sheet and the findings showed that most of the inventories were weapons. Another account in the balance sheet which is different compared to most organisations in the West is the amount of cash which is much more significant in the East.

Apart from the illegal activities mentioned previously by the interviewee, he says there are also other types of shadow activities. The interviewee admits that of course this was something that you had to be careful about. However, the experience that the interviewee refers to is more that of securities that were used for credit. The interviewee, who has experience in the banking industry, explains that there could be problems when assessing the risks associated with credits and securities.

Normally when you determine a credit risk you look at the security and a system which uses mortgage properties and other securities. This worked out well but what we did not realise when we came from Sweden, was that the system that registered all this was all right but it was another thing to get these securities if the creditor did not pay.

In the beginning of the transition this was a greater problem because the legal system did not work properly and bribes and 'off the books' money were more common back then. The black markets were socially accepted and, still are, although not to the same extent.

The main problem is that in a transition economy you have nothing to build upon, as you have no experience. Normally you have a tradition and some basis on which the new system can be founded. However, whatever is accounted for is done in the right way, but the problem is that not everything is accounted for. The interviewee refers back to his experience with banks and states in which money laundering was very common.

One explicit risk that the interviewee has experienced is money laundering. This is, however, not unique to the transition economies but rather a more common phenomenon in the transition economies. Furthermore, the interviewee explains that the going concern concept is a major problem in these regions. This was exemplified earlier with the example of banks that took people's money and promised high interest and then ran off with all the savings.

Even though the interviewee states that the foreign accountants were treated well and the domestic professionals were eager to learn it was (and still is), however, hard to get the relevant information for the simple reason that it does not exist. Information exists but it is principally comprised of statistical information which was used in the old system. A simple thing as accruals can cause confusion because the accountants in the transition economies are used to the cash-principle which was the principle used in the old system. To encourage thinking in new ways can sometimes be hard.

Market value properties, for example, are another problem, maybe more so in the beginning of the transition. Properties were valued according to a certain method. However, this valuation is based on the activities which are going on inside the building, i.e. what the building is used for. This is still a major problem in Estonia. One reason this is still a problem in Estonia is that it is such a small market and very few transactions are taking place within it. The same is true with shares and similar assets. In a small market it is easy to manipulate the value simply by buying a large quantity and forcing up the prices. If a property has been an asset in one and the same firm throughout the transition, the only thing you have to go on is the historical cost. However, it is not the historical cost which would normally be referred to; the situation was much different back then compared to something that is bought in a market economy at the same time. You can follow theoretical models to calculate a value but this is only a theoretical value which says very little about the real market value.

The interviewee has not, however, experienced any problems regarding trade secrets. He states that there has never been a problem in getting the information that exists as long as the person or persons involved understand what the external accountant wants.

It was very seldom or never, that you as an accountant when carrying out due diligence, did not get the information that you asked for.

In the interviewee's experience it is not only banks that are willing to share their information.

I have also been conducting due diligences in production companies in Poland and the attitude has been the same. They are all willing to share their information.

The interviewee admits, however, that due diligence may be perceived as a more positive thing than auditing. When you do due diligence you do it because someone is interested in investing in the company and that may be the reason it is easier to get information. If they do not give the information that the auditors have asked for no investment will take place. However, the interviewee has not faced any problems of this sort when auditing firms, and especially banks, in the transition economies either.

The main focus when conducting an audit in a transition economy is whether the entity is a 'going concern' and is laundering money. Another risk that occurred as a result of the Russian rouble crash was the exposure of the rouble economy. This was an additional risk which the auditor had to assess.

Some of the internal controls you have to ignore completely. They have no place in reality and are too influenced by the old system.

In the banking, if we use this example again. I have done auditing and due diligence until the year 2000. And in the reports we have more or less always concluded that the internal control does not fulfil any function. We simply ignored it. And what you have to do is to focus your work to compensate for the lack of internal control.

The interviewee further states that when doing an audit or due diligence you always know or strongly suspect that the internal control will not be of any help in your work. Furthermore, you are always prepared to check for money laundering and if the 'going concern' principle can be applied to the entity. These are the risks in the former Soviet Union and the other Eastern states and you have to make a statement about it.

The main theoretical problem which the interviewee refers to is detection risk. The problem here is that the people doing the money laundering are very professional and it is very hard to detect.

They have been operating since back in the old Soviet Union and all you can see is that they have a lot of Cayman Islands companies and you do not know who is behind it all. And here you do not get any information. In Russia they said that they believe that most of the properties in London are bought with laundered money.

The interviewee also says it is damaging for these countries, especially Russia, when much of the national capital is disappearing from the economy. It makes it harder to get investors because of this bad reputation related to money laundering and capital disappearing. Furthermore, they do not have a functional legal system and the market economy is not functional either. It is more like a pirate economy. This makes it impossible or at least very hard to jump start the economy with foreign investors. The interviewee believes, however, that the Baltic States have come further in their transition. They had a tradition of market economy prior to the invasion of the Soviet Union.

There are certain areas or risks which the interviewee believes that an auditor should focus on.

The old system has taught the people to get what they can which results in the money laundering and all that. They have just started from scratch and the old ways of thinking still exist.

4.3.4 Solutions to the Accounting and Auditing Problems

According to the interviewee, in order to solve these problems you have to hire taxation specialists because of the ambiguity of the taxation system. The system is very different from that of the West. If the taxation authorities are doing a tax audit of a company they have to find something. If they do not find something that will increase the tax for the company or they will get into trouble.

We were in St. Petersburg and they were carrying out a taxation audit of a company. They had not found anything but the auditor from the taxation authorities said he needed to find something. In the end they had to give him something relatively small so he would be satisfied. This is also a form of bribe because they worked on commission.

Another example given by the interviewee was when he worked in Moscow 1993-1994. A colleague phoned and cancelled a meeting saying that they had some problems with the taxation authorities. The taxation authorities had come in with armed police officers, cleaned the office out and took everything with them. The problem with ambiguous laws, especially concerning taxation, is that the laws are constantly changing. And the interviewee states that the hardest thing to do when conducting a due diligence is to assess the tax exploitation of the enterprise in question.

The interviewee does believe that he as a Western foreigner has a different way of looking at these problems. However, this is not necessarily a positive difference. The interviewee argues that someone who has grown up in a transition economy may find it easier to assess the risks he talked about earlier. The Western auditors work alongside the domestic accountants in the big firms to receive relevant output. However, the theoretical knowledge of accounting principles and the practical experience from someone who has worked as an accountant and auditor in a market economy is crucial. What you need is the combined knowledge and experience because you need the basic thinking of accounting and auditing the way it is done in the West, but you also need the local knowledge from someone who knows how and where to find these risks.

There are many things to think about and you need combined knowledge.

The most important thing for an auditor in a transition economy is to be aware of the problems that may occur. Furthermore, the interviewee believes it is necessary to penetrate these problems and to be diligent. Apart from this, an auditor needs to cooperate with the local professionals in order to understand their mentality and how things work.

We have been fooled. Just look at the banks in the Baltic States. There were 60-70 but now there are only 4-5 left.

The problems concerning debtors and bad debts exist in the transition economy in the same way as in the West. The interviewee argues that maybe Westerners are too credulous when it comes to this subject. If the directors in a company say they are going to get paid, the external auditor asks no further questions. The interviewee believes that auditors everywhere need to be more critical. However, in the transition economies the situation may be a little bit more extreme.

In the Baltic States and other transition economies this problem is worse and you can see very long and extended credits. However, if you do not have the money you can not pay.

4.4 Interview Four

The interviewee's country of origin is Sweden and he is an academic working with training of management and entrepreneurs in Lithuania and has been involved with the foundation of a business school in Vilnius, Lithuania. Furthermore, after finishing his PhD in management in the USA, the interviewee has continued his research in Sweden. The interviewee has been working with the Baltic States and management training since before the break-up of the former Soviet Union.

Interviewee number four has a different background compared to the other interviewees. The purpose of this interview is to get another view of the situation in the transition economies. Furthermore, as interviewee has more experienced in management training and management behaviour than in external accounting, the interview will focus mainly on management questions and questions regarding management behaviour.

4.4.1 General Accounting Problems in the Former Soviet Union

The interviewee states that, in his experience, the main problems in the former Soviet Union were not accounting. The lack of a sufficient way of accounting was, and still is, a minor problem compared to the main discussions regarding the transition. However, the interviewee still admits that the ‘old’ accounting methods were solely a manner of state control over production and other activities. The role of accounting was to ensure that the overall plan was being implemented at the micro level.

Furthermore, the interviewee explains that in order to succeed in business and to get a high ‘rank’ in a state owned enterprise one had to be a member of the party – read communist party. A manager had to be accepted by the higher sections of the hierarchy and do as he or she was told. There was no chance to implement own ideas or change the way things were done.

4.4.2 The Old System’s Legacies on Management Behaviour

Firstly, the interviewee points out that the old hierarchy still is present in the Baltic States and Russia. He, the interviewee, even goes as far as to argue that there really are no Baltic States or Russia; they still are one and the same. Because of the old hierarchy still rules, there is no point dividing the Baltic States and Russia. According to the interviewee, the old system, including the former KGB (the former Soviet Union intelligence service), has the best information, the best channels and contacts and definitely the best trained people and the best academics. This has a major influence on the current state of affairs. The old hierarchy lives on and the elite that were created in the former Soviet Union still are the elite. The interviewee further explains that the KGB had first pick on all Universities. This enabled them to create the absolute elite in the former Soviet Union. These people, even though no longer called the KGB, still are the elite and have the means to control the new transition economies.

However, even if the old system lives on in the sense that it is the same people at the top, there are exceptions. According to the interviewee, foreign companies and local management working within them are not normally influenced by the old system in the same way. A company from, for example, the USA has their own way of running things and the local management which are working in the company will adopt their behaviour. The whole company becomes much like an embassy in the way that things function differently. The top management is not influenced by the old system and the old hierarchy as they would have been if it was a domestic company. The ‘foot soldiers’, however, must have contact with local suppliers and creditors and they – the foot soldiers – must then be acquainted with the local hierarchy and the local way of doing things. Hence the management of all companies, even foreign, will be affected by the old system.

Another potential problem, or rather a difference between the West and the former Soviet Union, which was discussed by the interviewee, is trading with products and services. In the transition economies, trading is often done by means of products for products or services, i.e. with no money involved. This is also the case with information which makes the legacies from the past system more apparent because the old elite often have the best channels of information.

The trading abilities of the local management and dealers are considered very well developed and efficient by the interviewee. The Western way of considering the local management to be less efficient, the interviewee argues, is the result of neglecting to understand the differences. In the old system, a large proportion of the GDP was created by the black market and the shadow economy within the former Soviet Union. This, the interviewee argues, has resulted in that they – the entrepreneurs of the shadow economy – have developed a very skilful unofficial trading sector, even though they may seem unsophisticated in the eyes of the West. The unofficial economy, or the shadow economy, does include the ‘rules’ of supply and demand.

With reference to the apparent legacies of the old system, the interviewee explains that the shadow economy still is present in the new economy. This is not only a problem in the transition regions. However, theft and other problems related to the shadow economy are more apparent and wider spread in the former Soviet Union than in the West. The interviewee argues that all managers have had experience with disappearing truckloads if they are operating in the former Soviet Union.

4.5 Summary of Empirical Study

In this chapter we have heard from four interviewees, each with an expert and unique experience related to auditing, accounting, and business practices in the transition economies. Three of the interviewees are, or were, in professional accounting/auditing practice, and one is a management consultant and academic. All are knowledgeable and experienced with one or more of the transition economies. In certain areas, their comments reflect similar experiences and attitudes, while in others we have found interesting differences.

Having presented this empirical study of the interviews conducted during the course of the research, in the following chapter we turn next to the analysis. The analysis will present the ideas and opinions, coming from the empirical research, in the context of the theoretical framework. The analysis will compare and contrast the interview results, and will relate them to the theory.

5. ANALYSIS

This chapter analyses the findings of the empirical study by comparing them to the theoretical framework in chapter 3. Furthermore, the interviews will be compared with each other to give a deeper and more thorough analysis.

5.1 Introduction to the Analysis

The users of financial statement in the former Soviet Union states have changed radically since the beginning of the 1990's. This may have an effect on the preparation of the financial accounts and reports as the traditional 'Soviet' users still may have an influence on the information being prepared. By this, the authors of this thesis refer to the lack of experience of stock markets and similar markets in the former Soviet Union. Do the management and accountants know which information is important and can they produce it? Are they aware of the impact and that some information can have on the value of equity and the assessment of the enterprise?

The purpose of the financial reporting has changed in the transition economies from a more or less one single user – the state – to a number of users, all seeking different information. Is the new financial reporting system fully implemented? When preparing the financial accounts, are the management and accountants still influenced by the old system? Does the new economy accept the variety of disclosures?

The change in the structure of ownership is one of the basics for a successful transition from a planned to a market economy. However, this immediate change is bound to have inflicted some uncertainties regarding the responsibilities of the management. In the present state, the managing director is responsible to the 'private' owners and not, as before, to the state. This calls for a fundamental change of decision making as the managers are now assessed by the company's profits or the value of the equity. This is a significant contrast compared to the old system in which managers were assessed by their ability to implement the overall plan into the enterprise and to fulfil the quotas set by the authorities. Furthermore, the new economy has brought a new phenomenon into the micro level of the enterprises, namely competition, which is a result of multiple owners.

The privatisation has also, according to the theoretical framework, created uncertainties and problems in post-privatisation. One of these problems or uncertainty is the enterprise's state of affairs of the organisation prior to the transition and privatisation. Another post-privatisation problem is the legal ownership of the former state property. The legal rights are not always clear enough to identify the ownership of the property.

5.2 In-Depth Analysis

The empirical study made it clear that some of the theoretical problems which have been expected in transition economies are not as significant as suggested in the literature. However, the authors are aware that some of the theoretical problems are not directly related to financial reporting and auditing. Rather, they are general problems that undermine an entire nation which is in the process of a transition from a planned to a market economy and influence all types of activities. The authors have made an attempt to link those general problems to one specific activity, namely the auditing process of financial reports. There are, however, some theoretical problems which are more directly related to auditing than others, for example the ‘lack of information to determine market value.’ All these problems will be analysed and compared to the empirical study and the discussion will bring out the important problems with the help of an in-depth analysis.

5.2.1 General Accounting Problems in the Former Soviet Union

One of the main problems for organisations in the former Soviet Union was productivity, or rather the low productivity and profitability of the organisations. One of the accounting reasons for this seems to be the strict focus on details which results in a neglect of more important matters. The theoretical approach to this is the statistical accounting procedures described in Section 3.3.2.2. The statistical accounting suggests a need for details which is necessary as input in order to receive the final output, i.e. the statistics.

5.2.1.1 Statistical Accounting

The inefficiency concerning the statistical accounting is mentioned by ‘interviewee one’, who considers the focus on details to be the main disadvantage of the old system. However, the disadvantage with focusing on details should be explained as a focus on unimportant details, which results in a waste of time and resources. This lack of productivity is also recognised in the third interview. ‘Interviewee three’ argues that all resources were put into fulfilling the set targets, i.e. the plan must be fulfilled. This fulfilment of the plan could also be interpreted as a problem which pays too much attention to details. However, in the second interviewee it was stated that the most important thing in an organisation in the former Soviet Union was that everyone had something to do. ‘Interviewee two’ further states that the amount that had been accounted for was not controlled by anyone, and it was more important that there was a figure in the accounts. How it got there or what it meant was not important. This implies that they were only interested in details which could directly be implemented into the statistics.

5.2.1.2 The Interpretation and Usage of Accounting Information

The interviewees explain the problems in the former Soviet Union in different ways and their explanations can be interpreted differently. It is, however, the authors’ opinion that the different problems explained by the interviewees have the same source; the success of the enterprise was determined by the sole criterion ‘if they could fulfil the plan’, i.e. if they could sustain the targets, including keeping a certain number of staff occupied.

This has resulted in a low productivity because many resources were put into the fulfilment of the plan. Furthermore, as two of the interviewees stated – ‘interviewee one’ and ‘interviewee three’ – it has resulted in an unnecessary focus on details related to the plan such as metres or numbers produced. This implies that the way the information was used and interpreted was inefficient for no other reason than to make it compatible to the statistics and the overall plan of the total economy.

5.2.1.3 The Users of Financial Accounts

The information produced by the accountants in the former Soviet Union is very different from that produced in the West. According to the theory in Section 3.1, the information of which the financial reports are constituted is dependant on the purpose of the financial reports, the users of the financial reports and how much information should be disclosed (Hendriksen and Van Breda 2001, p.851). Disclosure will be discussed and analysed in the Section ‘Identified Accounting Risks in Transition Economies’.

The users of financial accounts are explained as ‘different groups which have a direct or an indirect interest and relationship with a business entity’ (Rutherford 2000, p.12). In the former Soviet Union and other Soviet type Socialist States the users are illustrated in Section 3.3.1. The sole user is the state and its different agencies. The information must be relevant for the ‘Gosplan’ which makes out the plan for the next year. The plan is based on statistics which implies that the purpose of the accounts and financial reporting is to provide this information. As the information produced by the accountants in the former Soviet Union was, it can be assumed, in accordance with the information sought by the user. This implies that they fulfilled the most important principle of financial reporting according to Atrill and McLaney (1999a, p.19) which is to provide information that is useful to those for whom it is prepared. However, the authors do not suggest that the accounting procedures and the information thereof were reliable and/or relevant. Moreover, as the users have changed, this ‘most important principle’ is liable to be neglected.

Based on the analyses above it could be argued that the main accounting problem in the former Soviet Union was the lack of multiple users. Furthermore, the sole user – the state – uses the accounting information as means to produce the overall plan. If one was to apply Figure 1 in Section 3.1.1.4 to the former Soviet Union the relevance of the information could be considered insignificant or non-existent; ‘interviewee one’ and ‘interviewee three’, who argue that much resources were put into details concerning the plan, suggest that the information is not relevant to base futuristic prognoses on. To the question whether the information is reliable ‘interviewee two’ suggests that in the former Soviet Union, nobody really checked the amount being accounted. This answer could be interpreted as that the information is not reliable in the sense that it does not include the whole of the businesses, i.e. a large quantity of information is not accounted for. Thus the final information which is presented to the user could not be regarded as reliable.

5.2.1.4 The Usefulness of the Financial Reports

The usefulness of the information is limited by factors such as comparability, understandability, and timeliness. The accounting procedures in the former Soviet Union were uniformed throughout the entire region. This implies that the comparability

is very high between firms in the same industry and also across different industries. However, according to 'interviewee two' the figures were not analysed but rather just an out-put of the mechanical process of the registration of transaction. This is a problem recognised by all the interviewees even though not described in the same manner. 'Interviewee one' argues that the accounting focused on details but had little application in reality. 'Interviewee three' explains the usefulness of the old system as summarised numbers, and there were no results to calculate; there was no profit and loss account, only figures which concluded how many units had been produced. However, the lack of relevant information does not influence the comparability; hence the comparability must be recognised as good even though the comparative information is of no value due to irrelevant information being compared.

The understandability could be argued to be high or at least adequate with regards to the simplicity of the information; it is presented in the same way – often a form of statistics – for all industries and is based on the plan which is done by the users of the accounts. Therefore the understandability among the intended users was presumably high, the assumption being that the users were familiar with the structure and function of the planning device. However, as mentioned by 'interviewee two', the information was not analysed. This implies that the information was not understood which in turn implies one of three different situations:

- Situation number one, the information suffered from a lack of understandability;
- Situation number two, the users were not qualified to interpret the information;
or
- Situation number three, the users did not care if the information was interpreted correctly simply because all they had to do was to put it into a theoretical plan which had little to do with reality; they did their job and got paid and implemented the information into the overall plan.

The last scenario is the most likely if one was to assume that if they did not do their job in a manner which their superior considered correctly they would be replaced. To explain this further, as long as it could be implemented into the plan everyone was satisfied. This argument is strengthened by 'interviewee four's' explanation of the old system in terms of the hierarchy. 'Interviewee four' explains that in order to reach a higher grade within the hierarchy one had to accept the way things were done and do what your superiors expected you to do. Hence there was no opportunity to implement a new way of thinking or valuation of activities in an enterprise.

However, 'interviewee four' further explains that a large proportion of the aggregated production was in the shadow economy. Moreover, many entrepreneurs who were operating within this unofficial segment of the economy developed high skills in their trade. It is important, however, to recognise that these entrepreneurs were dependant on the hierarchy and that the KGB could end their business if they wanted. Thus even the 'free' trade was under the hierarchy's microscope.

5.2.2 Identified Accounting Risks in Transition Economies

In the theoretical framework it is explained that the accounting procedures and principles were uniform in the entire former Soviet Union. However, these principles were based on the fundamentals of a socialist system and hence the principles of accounting were more like principles of Socialism. One major difference which could be considered fundamental for the two opposite economic systems is the allocation of profits which is illustrated in Figure 5; Section 3.3.2.2. This figure gives some understanding of the fundamentals behind the accounting principles of the former Soviet Union.

5.2.2.1 Profits and Profitability

The main difference between the former Soviet Union and the new economy, that is about to be developed and which could be analysed from the features of Figure 5, is that the profits do not serve to value the enterprise in the sense of efficiency or economic value. The very notion of profit as it is understood in the West did not exist. It is more of a report to the authorities of how much funds the enterprise needs and how much taxes it should pay. This shows the fundamental differences between the two systems and suggests major fundamental differences in the accounting principles. For example, due to the lack of the traditional Western notion of profits, it could be argued that there was no need for all resource allocations to be recognised as costs. Management bonuses and some capital charges were not considered as costs but rather as profit allocations. This implies that the cost of capital, for example, was not included in the overall valuation of an enterprise. This in turn suggests that the accounting principles would have been fundamentally different from those of the West.

‘Interviewee one’ states that the greatest fundamental disadvantage with the old system was its inability to establish a company’s profitability, for the simple reason that the information did not exist. However, ‘Interviewee one’ does not explicitly express that this problem with determining profitability has been carried forward in to the new economic environment. On the other hand, ‘Interviewee one’ does argue that the main problem according to her experience in transition economies is that the accountants had the old system in the back of their heads. This could be interpreted that fundamental disadvantages such as the lack of determining profitability have been carried forward into the transition phase. ‘Interviewee two’ and Interviewee three’ do not specifically state that the lack of a sufficient notion of profits and profitability are of any concern in transition economies. However, like ‘Interviewee one’ they argue that the lack of the whole concept of Western accounting – which, it could be argued, by definition, should include an understanding of profits – is a problem that has been carried forward into the transition process.

5.2.2.2 Accounting Principles

The analysis above strongly suggests that the accounting principles applied in the former Soviet Union are not synchronised or compatible with those in the West. Furthermore, this implies that the professionals in the former Soviet Union had little or no experience and no understanding of other principles. This statement is strengthened by the fact that the harmonisation within the former Soviet Union and other Soviet type planned economies was total, i.e. there was no need to learn or understand other

principles than the domestic ones. The fundamental differences have been carried forward into the new economy according to the interviewees. 'Interviewee four' also argues that many of the characteristics of the old system still are very much present in the new economy. The old hierarchy still exists even though it may have changed names. This strongly suggests that the switch of accounting standards does not mean a transformation of people's way of thinking.

Most transition economies have implemented IAS or another type of international accounting standards. However, as mentioned previously, the old system differed fundamentally from the new principles and as a result there was a lack of understanding. The way it was implemented, according to 'interviewee three' was that they – the transition economies – went from no real way of accounting to IAS without any real experience. This problem is recognised by the other interviewees as well. 'Interviewee one' states that the main question for an external accountant is whether or not the internal accountant has understood and correctly implemented the new rules and procedures;

The chief accountants within the firm had the old system in the back of their heads and when they applied the new rules mistakes happened.

The theoretical differences are evidently still influencing the accounting procedures even if the old system has ceased to exist. 'Interviewee two' points out the ambiguity regarding the laws, especially the taxation laws which have an influence on accounting procedures. 'Interviewee two' further states that the ambiguous taxation laws were, and still are, considered a major risk by foreign investors. However, the laws may not be influenced by the old system of accounting. They should rather be considered as a victim of a rapid transition and one could, with reference to that argument, suggest that they are explicit to a transition economy. However, it is important to point out that this problem regarding ambiguity of laws is not necessarily explicit to an economy in transition from a planned to a market economy. Rather, it could be argued to be a problem with any economy which finds itself in a transition from one more or less extreme to another which forces the economy to start from scratch.

Both 'interviewee one' and 'interviewee two' point out that these problems regarding misunderstanding and misinterpretation of rules, laws and principles are not, according to their experience, made on purpose. This strengthens the idea that it is the old system and the habits, enforced on the people, which are the cause of the problems. It is not the people themselves who are acting in an immoral manner or through lack of interest. Kizilyalli (1998, p.56) argued that even if the environment changes, the people will not change accordingly. The people will still possess the old habits and the old way of thinking to which they are accustomed. This could be argued to be evident in the empirical study when all the interviewees state that misunderstanding and misinterpretations are not made on purpose, but they are rather the result of a conflict between the old and the new system.

5.2.3 Auditing Risks in Transition Economies

The distinction between accounting risk and auditing risk can often be hard to identify. The reason for this is, in the authors' opinion, that an accounting risk is liable to become an auditing risk. The problem is to determine *when* a risk associated with accounting

becomes a risk that has more to do with auditing. However, the distinction made in this thesis is not absolute. Moreover, this part of the analysis will focus on phases 1 and 2 of the four phases of the audit process model as illustrated in Figure 2 (Arens and Loebbecke 1991, p.156).

Moreover, the auditing procedure is to ensure that the information in the financial statement gives a true and fair view. The information must be reliable and relevant, see Figure 1 (Atrill and McLaney 1999b, p.8.). The IASB (2001, p.56) describes the objective of financial reporting as:

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.

As stated in the quote above, the objectives are to provide information to a wide range of users and the information should be relevant and reliable enough to base economic decisions on. It is the auditor's task and responsibility to ensure that the information fulfils those criteria. As stated by Davies *et al.* (1999, p.236), the auditor's main duty is to determine whether the recorded information properly reflects the events and actions that occurred in the accounting period, i.e. do the statements show what they are supposed to, namely a true and fair view in compliance with accounting standards' requirements. However, in a transition economy, the situation is different, although the rules of 'Western' accounting and auditing should be applied.

The theory suggests a number of liabilities associated with auditing in transition economies. However, the theoretical framework often emphasises different problems than the empirical study has shown. The theoretical problems identified by the authors can be summarised as follows:

- ***Shadow activities.*** These activities have been developed as an alternative market in the former Soviet Union economies. They are in many ways, it could be argued, a substitute for the lack of a competitive market because the rules of supply and demand have been neglected in the economy prior to the transition. Some of these activities have emerged into mafia-like organisations whereas some just live on because of 'tradition'.
- ***The economics of transition.*** The economic problems which are likely to occur in a transition economy may have an influence on auditing procedures. One of the major problems mentioned in the theoretical framework is inflation which is a common element in transition economies. Furthermore, the lack of practical experience and theories based on empirical studies and the lack of reliable data are other problems which may influence accounting and auditing.
- ***Social attitudes and cultural inheritance.*** For example, the shadow activities are not considered criminal in most cases. Their development was natural and common and an economic transition to a market economy will not erase years of social culture and attitudes.

- ***The accounting profession.*** Is the accounting profession in the transition economy equipped to handle the new economy, have they enough training and experience? One fundamental problem could arise due to the lack of both theoretical and practical experience of ‘Western’ accounting principles. Has the new role as auditors and not state regulators and controllers been implemented to a satisfactory level among accountants?
- ***Attitudes toward accounting.*** Accounting was, during the Soviet era, a way for the state to control management behaviour. Even though auditing in the Western tradition also is a way to ensure the legality of the actions undertaken in an enterprise, there is no controlling device equivalent to that of the former Soviet Union. The legacy of the old system may have resulted in a negative attitude towards accountants – a general mistrust because the accountants remind them of the old system.
- ***Availability of information.*** In the Soviet era, information was kept in order to use it to gain power. This may have resulted in a legacy which carries on this tradition. This is also related to the attitudes toward accountants explained above. A potential problem lies in the evidence that the auditor needs to verify the information given by the enterprise. Is there sufficient evidence for the auditor to use in order to determine the relevance and correctness of the information?
- ***Management behaviour.*** Are the managers equipped to make decisions in an economy in which the price mechanism plays an important part? The role of the management will be more flexible and wider knowledge and skills will be necessary. This may be a problem when assessing a firm’s value and may lead to uncertainties regarding the responsibilities within the firm. To what extent will the defects of ‘Management Sovieticus’ still have an impact on management during the transition?
- ***Internal control systems.*** Is the internal control support reliable? This is a potential problem which the auditor might have to consider regarding enterprises in transition economies.
- ***Legal aspects.*** Even though the ownership has changed from state to private persons and organisations, there are still uncertainties regarding the ownership of properties. This could be a major problem for an auditor who must clarify this in order to conduct the audit.
- ***The implementation and understanding of new accounting principles.*** As mentioned before, the accountants in the former Soviet Union had no reason to learn accounting principles from outside the Union or other Soviet type planned economies. As the accounting principles were fundamentally different due to factors as single users, for example, there might be a lack of understanding of the new principles.

The theoretical problems explained above will be further analysed and compared to the empirical study. However, the order in which they are explained are not of any relevance and the further analysis will mix these risk factors. The reason for this is that

many of the problems and risks stated above are related and it is not feasible to single them out one by one for analysis. Social attitudes is one subject that has a broad effect and will reoccur under most headings. Such analysis would also make deeper analysis incomprehensible or repetitive. Therefore, the various headlines which have been chosen give the analysis structure without losing its comprehensiveness.

Moreover, in addition to the analysis of the explicit auditing problems in transition economies, a recommendation or suggested solution will be analysed, when possible to identify, at the end of each Section. The solution part of the analysis concerns what Arens and Loebbecke (1991, pp.157-158) refer to as Phase III in the audit process model; 'perform analytical procedures and detail tests'.

5.2.3.1 Culture and Economics of Transition

Shadow activities are, according to the secondary studies in the theoretical framework, a major problem in all or most of the transition economies. The theory suggests that one of the problems regarding 'Management Sovieticus' was the liability of wasting and hoarding factors of production (Liuhto 1993, pp.9-17). Furthermore, Lavigne (1999, pp.9-10) argues that the shadow economy or shadow activities are one of the most damaging legacies from the past in a transition economy. This is verified by 'interviewee four' who argues that most, if not all, companies who are dealing with a transition economy, with special reference to Lithuania, will experience problems with the disappearance of truck loads. 'Interviewee four' further explains that this is a phenomenon which you have to accept in these regions.

The problem of shadow activities and illegal activities is liable to arise even after the transition has started. The reason for this is that the social atmosphere, to a certain extent, accepts such behaviour. If it is socially accepted to take resources from an enterprise and sell them for personal benefit, this is more likely to occur than if it was frowned upon. One could make comparison to any organisation where it is accepted to take home office supplies. If this is the case most staff and managers would probably do so.

The statements above suggest that shadow activities will occur in the former Soviet Union. It is thus fair to argue that these activities, which are considered a general problem in transition economies, will have an impact on the planning and testing phases in the audit process model. One explicit risk that 'interviewee three' has experienced is money laundering. This is, however, not unique to transition economies but is rather a more common phenomenon in the transition economies. However, the empirical study shows no other evidence of shadow activities being a problem when it comes to auditing. 'Interviewee two' argues that he has not had any significant problems with shadow activities. 'Interviewee one' states that, in her experience they – the auditors – had not noticed any problem regarding shadow activities. However, one could argue that if done properly by professional 'criminals' you can not detect or notice the shadow activities. Furthermore, if this has been an activity which has been developed during a long period, one could argue that the people involved are professionals who do not make (beginners) mistakes, which make the detection risk smaller.

'Interviewee two' admits that shadow activities exist but says he has no personal experience of them. However, he states that they are most likely to occur in old state

owned entities and it has not been a problem in the private sector. This seems to agree with the theoretical framework as many of the problems associated with a transition economy are directly linked to the old system. This is also in accordance with 'interviewee four' who argues that the old hierarchy and its legacies are less apparent in foreign companies, which implies that they are more common in domestic, former state owned enterprises. One could then argue that the connection between old state owned properties and the old system would be more apparent. The former state owned enterprises are less likely to have gone through a change of management and the implementation of new ideas could be argued to have been less successful. A similar argument is stated by 'interviewee four' when explaining that the foreign enterprises have another atmosphere which is not dependant on the old hierarchy which still exists in the transition economies. The exception for this are the dealings with the local community where the old hierarchy very much is still present.

According to 'interviewee two' one of the main risks, especially at the beginning of the transition, was inflation, or rather hyper inflation. This hyper inflation must be accounted for somehow and the risk which it will enforce on, for example, creditors and lenders, must be clearly stated. The objectives of financial statements include, according to the IASB (described in Chapter 3) to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. The wide range of users who also are described in Chapter 3 implies that the auditor must assess the enterprise in question in a way that satisfies not just one single user.

However, the problem regarding inflation is not mentioned by any of the other interviewees. This could be argued to suggest one of the two following situations:

- Situation number one. The inflation was more apparent in Romania where 'interviewee two' has more experience. This does not mean that the other transition economies have not experienced inflation which, according to the theoretical framework, is one of the most common problems in transition economies. However, the inflation may have had a greater impact on economic decision making in Romania than in other countries; or
- Situation number two. In the regions where the other interviewees have been and are active – i.e., in the Baltic States and Russia – inflation was a problem, even an accounting and auditing problem. However, it was a problem which was easily dealt with in auditing and financial reporting. Thus, the interviewees did not reflect on inflation when discussing accounting and auditing problems in transition economies.

Another problem, which is more related to culture, is the situation when it comes to paying debts. 'Interviewee two' explains that this can be a problem on occasion because, when it comes to paying your debts, it is customary to delay/avoid payment and it takes a long time to get all debtors to pay. According to 'interviewee two' this is a major risk in the transition economies. It is the authors' opinion that the source of this, to a certain extent, is the ambiguous laws and the lack of 'going concern' which are analysed later on in this chapter. If an enterprise owes a bank or enterprise money, it may be reluctant to pay if the creditor will be bankrupt in the near future and the laws

are not clear regarding the obligations of the debtor after the bankruptcy. If there is a possibility you may not need to pay if you wait, why pay now?

Solution Analysis

‘Interviewee three’ explains that he has experienced problems regarding money laundering. This problem was minimised by that the auditor has to look more carefully at the balance sheet. According to ‘interviewee three’ the findings were often that a large amount of inventories was constituted of weapons and the amount of cash was much more significant than in the West. This, ‘interviewee three’ argues, was an indicator that the ‘going concern’ principle would not be applicable and the bank had the possibility to run off with all the enterprise’s assets.

Even though not recognised as a solution to the poor attitude concerning paying debts as such, the classification of bad debts could still be argued to be a kind of a solution. Bad debts are not, according to ‘interviewee three’ recognised as soon in transition economies as in the West. This implies that the debt will be paid sooner or later. ‘Interviewee three’ explains that even if the debt is over a year due it may still be paid, and thus the different view of bad debts can be argued to be an imperfect solution.

5.2.3.2 Availability of Information

In the planning process described in Figure 3 in the theoretical framework, it is illustrated that the gathering of information is a crucial part of the audit process. However, in the theoretical framework it is also argued by Lawrence and Vladchoutsicos (1990 cited Liuhto 1993, p.16) that withholding of information was a common characteristic among the management of the state owned enterprises. With reference to the cultural inheritance, which the new economies have inherited from the former Soviet Union, the withholding of information may still be a characteristic of management. However, ‘interviewee four’ explains that the old hierarchy and the legacies of the old system are not as apparent in foreign enterprises. This implies that the legacies of ‘Management Sovieticus’ has no effect on foreign enterprises. Rather it is a problem for former state owned enterprises and domestic companies with no foreign investors.

Furthermore, ‘Interviewee two’ explains that the relationship between the management in the companies and the accountant who is doing the auditing can sometimes be troublesome. He – ‘interviewee two’ – sometimes got the impression that the companies do not fully trust the external accountant’s confidentiality. This statement, one could argue, shows that the legacy from the past concerning the tendency to withhold information is still evident in the transition economies.

Moreover, ‘interviewee one’ explains that in the new system there is a lack of trust among all parties involved. It is assumed this includes the trust between the external auditor and the management and internal controller of the enterprise. This implies that there can be problems gathering the information which is necessary to carry out an audit properly. This argument is strengthened by ‘interviewee one’ and ‘interviewee two’s’ statements that a large quantity of information which does not qualify as trade secrets in the West would be considered such, both in the former Soviet Union and in the present transition economies. ‘Interviewee three’, on the other hand, explains that he has not

experienced any problems regarding trade secrets or any other problem relating to the gathering of information.

It was very seldom or never, that you as an accountant when carrying out due diligence, did not get the information that you asked for.

In addition to this, 'interviewee three' explains that he has been conducting due diligences in more than one transition economy and the attitude has been the same. They have all been willing to share the information they have. It is, however, the authors' opinion, and also the opinion of 'interviewee three', that due diligence is conducted because someone is interested in investing in the company and that may be the reason it is easier to get information. If an enterprise does not give the information that the auditors have asked for, no investment will take place.

Another problem which has been identified in the empirical study is that of determining market value on properties. This is a type of valuation which, according to Jaruga (1996, p.15) in the theoretical framework, did not exist in the former Soviet Union. 'Interviewee two' states that when it comes to properties, there have been, and still are, some problems in determining their market value. Market value did not exist in the communist regime and it is hard to obtain relevant information regarding ownership and transactions.

'Interviewee three' explains that market value of properties is a problem which generally was more apparent in the beginning of the transition but is still a major problem in Estonia. Properties were valued according to a certain method. However, this valuation is based on the activities which are going on inside the building, i.e. what the building is used for. 'Interviewee one' confirms this problem by stating that there was no relevant information on which the market value on properties and other assets could be based.

Furthermore, according to 'interviewee one' there were so few transactions that had been recorded, so even if something had been sold, it was difficult – or even impossible – to determine who had bought what from whom and under what circumstances. Much information was hidden in the secrecy which existed among companies.

The lack of information regarding market value is an area which, apparently, has caused and still is causing problems for auditors when applying the new rules and standards. However, based on the information received from 'interviewee four' regarding the functional unofficial shadow economy, one could argue that for many buildings a market value must exist. The unofficial economy is, as suggested by interviewee four, based on supply and demand. This implies that the market values were determined and that prices were based on this. It could then be possible that market values existed for properties. However, even if these market values would have been present they would not be properly recorded. Moreover, the market values would only have been present in the black market which suggests that these values are not applicable.

Solution Analysis

According to 'interviewee two' some necessary information is inaccessible, which implies that the audit can not be properly conducted.

Sometimes you just don't get the information you need and there is no way to solve it. The result is often that the auditors' report will be qualified.

This implies that there is no apparent solution to the dilemma. However, as the interviewees consistently, with the exception of 'interviewee one', have made reference to that people in these regions think differently. The audit process and other activities concerning financial reporting, and in the case of 'interviewee four' management, gets easier the longer you work with these people so one possible solution can be suggested. The more knowledge and understanding the auditor gets about the economy and the people, the more accurate will the financial report be. However, as this may not always be possible, it could be argued that the assistance of qualified, domestic professionals will, to a certain extent, minimise some problems.

The problems regarding market value of properties were solved, according to 'Interviewee one', by means of valuing them on the basis of the old system which had valued properties in accordance with something which could be referred to as taxation value. 'Interviewee one' explains that there was nothing else to choose as a substitute for market value.

5.2.3.3 Management Culture and Internal Control Systems

The management behaviour and the behaviour of owners seem to be very different from that of the West. 'Interviewee two' states that when an audit has resulted in a qualified report, the management and the owners do not seem to care. The fact that the audit has resulted in a qualified report is not considered as a negative outcome. Presuming that the management and board of directors of the enterprise are behaving rationally, the fact that they ignore a qualified report suggests that it will not have a negative effect on the enterprise. Furthermore, this also strengthens the argument made before regarding the difficulty of gathering information necessary to conduct the audit. If the board of directors does not care if the financial reports are qualified, then it seems more likely that they or the managers do not want to spend time on giving the external auditor information. If they do not care about the output, why care about the input.

Moreover, 'interviewee four' explains that the unofficial economy, or the shadow economy, has resulted in the development of a very skilful trading sector, which may seem unsophisticated in the eyes of the West. The term unsophisticated may be interpreted as different in the sense that they do not use the same methods and systems as the West. This implies that, assuming that they are efficient and that the market is efficient, they are not interested in changing to a system they do not understand and which, in their mind, has no practical function. This argument, together with the statement made in the previous paragraph by 'interviewee two' suggests, maybe not unwillingness, but a view of the new accounting methods and principles as unnecessary and perhaps impractical.

Another problem which has been identified in the empirical study is the problem regarding if everything is accounted for. 'Interviewee three' explains that whatever is accounted for is done in the right way but the problem is that not everything is accounted for and refers back to his experience with banks and states in which money laundering was very common. 'Interviewee one' also argues that everything was not accounted for which, she explains, from an auditing point of view, is very hard to

check. This problem could also be argued to be explained in the theoretical framework by Liuhto (1993, pp.9-17) who states that wasting and hoarding of factors of production was a common problem regarding the 'Management Sovieticus'. If managers are still using the enterprise's factors of production for their own benefit, it is reasonable to argue that they do not account for everything unless they want to be found out.

According to the theoretical framework it is crucial that the auditor understand the client's internal control structure in order to plan the amount of audit evidence necessary. 'Interviewee two' argues that in a transition economy you can not trust the internal control. The internal controls are not sophisticated enough and do not detect any problems or mistakes. This implies that the control risk is significantly higher than in a generally Western enterprise.

'Interviewee three's' experience seems similar to that of 'interviewee two'. 'Interviewee three' explains that some of the internal controls you have to ignore completely. They have no place in reality and are too influenced by the old system.

In the banking, if we use this example again. I have done auditing and due diligence until the year 2000. And in the reports we have more or less always concluded that the internal control does not fulfil any function.

This statement confirms that of 'interviewee two' and, with reference to the theoretical framework, is a liability which, it could be argued, has had a great impact on the auditing procedure.

Solution Analysis

The legacies from the 'Management Sovieticus' were solved, or attempted to be solved, not by the auditors but by the authorities. 'Interviewee two' explains that the problems regarding the management culture has been resolved by new laws which give the managers more responsibilities. For example, the manager in charge of stocks or inventories is also responsible for each product; he or she is personally liable to pay for everything missing.

However, the explanations by 'interviewee one' and 'interviewee two' do suggest that the new laws are not sufficient. Detail testing seems to be necessary, not only to complement the lack of internal control as analysed below, but also to ensure the auditor that the managers' behaviour is in accordance with regulations.

As mentioned previously, Phase III in the audit process model is assumed to be of more concern in transition economies. According to 'interviewee two', the lack of internal control in the companies is solved with detail tests. This conduct of detail tests, 'interviewee two' argues, results in that there is little risk that the accountant or auditor will miss anything. Both 'interviewee one' and 'interviewee two' argue that when you are auditing a company in transition economies you have to be prepared to allocate more time and resources compared to the West because of the need to carry out detail tests in enterprises in transition economies. 'Interviewee two' even suggests that it will probably take twice as much time to conduct details tests of an enterprise in a transition economy as it would in a Western enterprise.

The additional time and resources that the auditors spend on detail tests implies that it could be contradictory regarding the sixth characteristic – cost/benefit – presented in Figure 1 in the theoretical framework. However, as explained by ‘interviewee one’, detail tests was not as expensive in Latvia because salaries were lower and you could put four assistants on a job like this which would have been very expensive in most other countries. It is the authors’ argument that this statement could be generalised throughout the former Soviet Union and other former Soviet type planned economies. The generalisation is based on that salaries are generally lower in all transition economies than in the West.

5.2.3.4 Implementation of New Accounting Principles

One of the main problems regarding the implementation of new principles which has been identified is the problem for the auditor to determine that the internal accountant had fully understood the new accounting principles and procedures. ‘Interviewee three’ argues that the general auditing risk was, and still is, that the internal accountant does not have the knowledge to prepare the accounts. According to ‘interviewee one’, the main problem regarding auditing in Latvia, as a result of the transition, is to know whether or not the companies have fully understood the new rules.

The previous paragraph suggests, which is also confirmed by ‘interviewee one’, that there is a liability for problems of a very general or basic nature to arise. For example, ‘interviewee one’ explains that there could be many fundamental errors concerning, for example, depreciation and other accounting techniques with which they were not familiar.

As described before, the enterprises in the former Soviet Union had no real notion of profits and profitability as it is understood in the West. Furthermore, as illustrated and described in the theoretical framework, there was only one user – the state – who also was the owner of the enterprises. With reference to this, one could argue that there is no direct risk of the owner stopping production if this is not planned. If planned, this would be in accordance with the overall plan and not a risk as such for the accountant as he or she presumably would have been informed. Moreover, the distribution of profits, which is also illustrated in the theoretical framework, suggests that there is no liability for bankruptcy. The lack of these risk elements of the owner stopping production, whatever the reason, or bankruptcy, implies that an evaluation by an auditor or any authority regarding these matters was unnecessary.

The analysis in the previous paragraph has been identified as a potential problem when an economy is changing from planned to market. During the Soviet era, there was no private ownership, but this changed during the transition which gave private owners the opportunity to take advantage of the situation. ‘Interviewee three’ explains that the ‘going concern’ principle, which is a legal problem relating to the disorder of affairs which is present in many of the transition economies, was an explicit risk which he has experienced. The interviewee refers to the mafia controlled banks and other banks who did not operate legally.

In the theoretical framework Jaruga (1996, p.15) explains that in the former Soviet Union there was an incomplete accrual accounting, i.e. there was no matching of revenues and costs to the relevant period, i.e., in the former Soviet Union they applied

the cash principle. The use of the cash principle in the former Soviet Union is the next explicit problem which has been identified in the transition economies. 'Interviewee two' argues that this has been a critical problem which the auditor has to consider. 'Interviewee three' agrees and states that a simple thing as accruals can cause confusion because the accountants in the transition economies are used to the cash principle.

The previous paragraph gives a good example of a theoretical legacy from the former Soviet Union. 'Interviewee one' explains, even though not specifically pointing out accruals as a problem, that the internal accountants still had the old system in the back of their heads. It could be argued to be reasonable to assume that 'interviewee one' includes the lack of understanding regarding accruals in her statement.

It was explained by 'interviewee four' in what he called a difference between the transition economies and the West, that trading with no money involved is a common feature. 'Interviewee two' gives a similar example of problems which he has experienced in that trading with debts and credits could cause problems for an inexperienced auditor. This problem has not been specifically been described in the theoretical framework which could be the result of the lack of general experience on the subject.

Solution Analysis

The implementation of the new accounting principles is evidently a slower process than one might think at first. The solution to this problem seems to be to constantly reassure oneself that the new principles have been understood and implemented in the right way. Moreover, according to 'interviewee one' and 'interviewee two' it is also necessary to carry out detail tests in order to determine that the new principles are correctly understood and that no mistakes have been made. This implies that, as 'interviewee three' put it, an auditor has to go 'back to basic' to successfully conduct an audit in the transition economies.

With reference to the statement in the previous paragraph one could argue that detail tests are necessary, not only as a substitute for the insufficient internal control but also as a tool to make sure the new principles are understood.

5.2.3.5 Taxation and Legal Aspects

In the former Soviet Union the state received money from the enterprises in terms of profit allocations as illustrated in the theoretical framework. It could thus be argued that it is crucial for the state, when the old system is being replaced, to implement tax laws which will generate the necessary revenue for the state. 'Interviewee two' explains that one principal problem is the law and the way it is written. The taxation laws are very general in nature and they are so for a reason. The taxation officers seek an opportunity to collect fines and more tax for non-compliance with rules and regulations.

Another problem regarding the legal system and the laws is identified in the empirical study. 'Interviewee three' explains that in the transition economies they tend to not have a functional legal system. Whether or not 'interviewee three' includes tax laws in this statement is not verified. However, the authors believe that the ambiguity regarding the legal system can be viewed as a general phenomenon in the transition phase when switching from a planned to a market economy. Two of the interviewees – 'interviewee

two' and 'interviewee three' have had experience with problems regarding the legal system. Even though the problems have been of a different nature, it does suggest that the creation and implementation of new laws is a problem for auditors of financial reports.

The ambiguous laws – as 'interviewee two' explained them – can be argued to create liabilities in several main areas. Firstly, there are the taxation laws, which the taxation commissioner interprets differently from time to time in order to find faults which will result in commission. Secondly, the laws are not straight forward and there is a liability for problems regarding, for example, ownership and the implementation of laws. This was exemplified by 'interviewee three' who explains that the legal system was also a problem regarding securities. Even though a security for a loan was valued it is not necessarily the case that the lender, for example, a bank, would get access to the security.

Solution Analysis

None of the interviewees argued for any apparent solution to the problems identified in Section 5.2.3.5. However, it could be argued that a legal advisor, knowledgeable about the new system, is more necessary in the transition economies than otherwise. Furthermore, 'interviewee two' explains that many transition economies have changed their laws in order to gain access to the European Union, which implies that this problem will be of less importance in the future.

One solution, even though it may seem unconventional and bold to suggest, can be identified regarding the problem stated by 'interviewee two', that taxation officers get a commission on taxes and fines they gather. If this is a problem, an enterprise could make one or two mistakes not very serious in nature. This, it could be argued, would make the process slower because the taxation officer would find the mistakes and complete his or her task. This in turn, would get the problem out of the way and the auditor could carry on with the audit. Furthermore, there would have to be a wager concerning which costs that would be the greater; the fine regarding the 'mistakes' in the taxation or the additional hours that the auditor has to spend while the taxation officer is looking for faults and mistakes.

5.2.4 Analysis Discussion

The interviewees have different experience from different transition economies. 'Interviewee two', for example, has less experience from Russia and the Baltic States than the others. This is reflected in the analysis. However, it has not, in the authors' opinion, made the analysis less reliable or otherwise had a negative influence. Furthermore, 'interviewee three' has had more experience of banks and due diligence which, of course, has had an impact on his answers. Even here the authors do not believe it has done the analysis any harm. As explained before, 'interviewee four' has little or no experience regarding financial reporting and auditing from an auditors' point of view which may seem strange. However, the purpose of interview number four was to gain a more general understanding of the trading culture and to implement this in the analysis.

The authors have during the interviews and analysis considered the fact that some information may be influenced of the background of the interviewees. However, this

this thesis does not compare different accounting firms and the interviewees are anonymous. This implies that there is little risk that the interviewees have been biased when taking part in the interview. However, 'interviewee one' is a native of Latvia which could imply that the questions in interview number one are responded to subjectively. However, even though the authors admit that this may be the case, it has not been evident. The authors do believe that some bias is always unavoidable and that 'interviewee one's' background as a native Latvian and a Western accountant is a major advantage to this thesis.

Furthermore, the implementation and understanding of new accounting principles have been identified as a main auditing risk in the transition economies. However, the responses from the interviewees regarding this problem have indicated that the mistakes are not done on purpose, but rather a result of the transition. 'Interviewee one' stated that the problem was that the way of thinking was wrong, although it was not deliberate. 'Interviewee two' explains the situation as that people in the transition economies think differently, and they have another way of looking at things. This statement suggests, as did the previous statement by 'interviewee one', that the mistakes are made purposely. It is not the people's fault that these mistakes are occurring and reoccurring; it is rather a phenomenon which seems necessary in order to get through the phase of transition.

5.3 Summary of Analysis

In this chapter the similarities and the differences, with reference to the interviews in the empirical study, have been analysed. Furthermore, the problems suggested in the empirical study have been analysed in contrast with the transition environment and related theory. The analysis has also presented to the reader the ideas and opinions of the authors and how these have influenced the conclusion.

Having presented this analysis, in the next chapter we turn to the conclusion. The conclusion will conclude and summarise the identified problems based on the analysis. Furthermore, the next chapter will also present recommendations to future research on topics which have been discussed in this thesis.

6. CONCLUSION

In Chapter 6, the analysis will be concluded and the thesis question will be answered. Section 6.1 will summarise the potential risks which have been identified and that the old system may inflict on auditing in the transition phase. Section 6.2 will summarise the identified risks which are, to a certain extent, explicit to transition economies. This Chapter will also give suggestions for further study on the topics which have been discussed in the thesis.

6.1 Conclusion Overview

The conclusion of this thesis is that the auditing risks in transition economies can be divided into two different categories. These two categories have caused the problems regarding auditing in different ways but are none the less equally important to recognise. However, it is the authors' opinion that some of the accounting and auditing problems that existed in the former Soviet Union have been actualised and made more significant by the transition.

Category one, auditing risks associated with the legacies from the Soviet type planned economic system

This category consists of the accounting and auditing problems which the old system has directly inflicted on the current accounting and auditing environment. The problems in this category are the former planning system and accounting principles which have influenced the accounting procedures during the transition. Furthermore, 'Management Sovieticus', the old management style of the former Soviet planned economy, is also a legacy from the past which still influences the auditing process in the transition economies.

Category two, auditing risks associated with the transition from one economic system to another economic system

This category consists of the problems caused by the radical change of economic system which all transition economies have experienced and which they still experience. These auditing problems are not necessarily a product of the old system in the former Soviet Union and other former Soviet type planned economies. The problems are rather a product of the radical change in, for example, structure, ownership, and new laws which have been changed in order for the economies to successfully implement a market economy.

The authors would like to point out the problems regarding the implementation of new principles have their source in both the old system and the transition phase. Hence it will be concluded in both categories but in a different manner.

6.2 Auditing Problems in Transition Economies of Category One

6.2.1 Implementation of New Accounting Principles

The accounting principles in the former Soviet Union include the cash principle which is contradictory to the principles which are being implemented. Specifically, the accrual principle, one of the main accounting principles in the West, has been neglected in the former Soviet Union. The neglect of these principles in the former Soviet Union has resulted in that there is little understanding of those principles which are meant to be implemented.

The implementation of new accounting principles is of major concern for the external auditor. With reference to the previous paragraph, it has further been concluded that the auditor is likely to find that the new accounting principles are not understood correctly at all times. The problem here is that the auditor has to make sure that the internal accountant has correctly prepared the accounts according to the new principles.

6.2.2 Internal Control Systems

In the former Soviet Union the internal control was only concerned with certain aspects of control such as if the overall plan was being implemented. This has resulted in that the internal control today in the transition economies is an auditing risk if the auditor believes that he or she can trust the information produced by them.

6.3 Auditing Problems in Transition Economies of Category Two

6.3.1 Culture and the Economics of Transition

The shadow economy is not of any significant risk with regards to auditing in transition economies. Shadow activities are more likely to occur in the old state owned enterprises. However, one auditing risk which does exist in the transition economies is money laundering. Furthermore, inflation has also been a problem which the analysis verified. However, it has not cause any significant auditing problem more than in the case of the hyper inflation of Romania.

Moreover, it has been concluded that the different business approach (compared to the West) to paying debts can be of some problem for an external auditor. One of the sources behind this tendency to wait with paying debts is the ambiguous laws and the nature of the transition which seems to be disorganised, as well as the pirate economy.

6.3.2 Availability of Information

Availability of information does have its source in the former Soviet system and culture. The authors do, however, believe that this problem has more to do with the transition

phase. The transition has resulted in that much necessary information is not available for the simple reason that it does not exist. The main problem here is to determine market value of properties.

6.3.3 Management Culture

The management culture in the Soviet Union, ‘Management Sovieticus’, is a liability in the sense that the management in some transition economies tend to be indifferent towards the external auditor and the financial reports. This problem, as well as the availability of information, has its source in the former Soviet Union where information was considered as a source of power. However, the transition has brought in a new way of thinking which the old management does not seem comfortable with. The problem here is that the local management does not seem to care whether or not the financial reports are unqualified.

6.3.4 Legal Aspects

The legal system with reference to taxation and ownership has changed radically since the transition started. This has resulted in that the laws are to be considered as ambiguous in nature. This has especially resulted in auditing problems regarding taxation. It seems to the authors that it is extremely difficult for an auditor, even with legal help, to determine the taxes which an enterprise is going to pay.

Furthermore, the laws regarding ownership of properties and other assets are also to be considered ambiguous. The problem here for an auditor is to determine if the enterprise in question actually is the owner of its assets. This is also a problem with reference to determining the value of securities. An auditor has to be sure that the lender actually and rightfully owns the security in question.

6.3.5 The ‘Going Concern’ Principle

The ‘going concern’ principle is an explicit problem for the auditor in the sense that some enterprises, especially banks, could be operated illegally and do not have the purpose of going concern. In contradiction to the implementation problems in category one, this problem is more related to the transition environment and not to the old system.

6.4 Solutions to the Accounting and Auditing Problems

Some of the explicit auditing problems in transition economies which have been identified do not have a satisfactory resolution. The unavailability of information is one problem which sometimes can be solved; the result is that the financial report may be qualified.

The solution to many of the auditing problems is that the auditor has to perform detail tests. The implementation of new principles, which are of concern for the auditor, can be solved by detail tests of the accounts. The auditor has to make sure that even simple

things as depreciation have been understood and accounted for. Detail tests are also the suggested solution to the lack of internal control.

Furthermore, a thorough analysis of the balance sheet could be the solution to problems regarding 'going concern'. If, for example, weapons constitute a significant proportion of the assets in the balance sheet, this may be an indicator that the business is of a less reliable nature. Moreover, it can be concluded that firms taking part in illegal activities often have a tendency to have more cash in the balance sheet than would be considered as normal.

6.5 Final Words and Recommended Future Research

The authors believe that many of the problems identified and concluded in the thesis will be less apparent in the future. It is, however, difficult to speculate how long it will take before the transition economies have overcome the explicit auditing problems, which are a product of the old Soviet type planned economic system and the transition to a market economy. There is no comparative historic event that the current situation can be compared to. However, many of the transition economies are joining the European Union in 2004 and some are seeking entrance at future dates. This will no doubt have a positive impact on the matters and will also have a positive impact on the international harmonisation of accounting principles, standards, and procedures.

With reference to this thesis there are two areas which the authors find especially interesting for future studies. Firstly, it was suggested in the empirical study by 'interviewee two' that the West, with special reference to Sweden, is neglecting the importance of detail tests. It could be argued that recent scandals, such as the Enron scandal, have resulted in that auditors have a more sceptical approach when conducting an audit. It is the authors' recommendation that a study is carried out to determine if the usage of detail tests has become more common since the recent scandals.

Secondly, the authors suggest further study on the topic of accounting and auditing in transition economies. This study could discuss how a sound financial reporting system would benefit and encourage the transition from a planned to a market economy. Such a research could, to a certain extent, be a joint study in accounting and, suggestively, macroeconomics.

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Interviews:

Interviewee 1: Retired accountant at one of the main accounting firms
Place: Via telecommunication (speakerphone) at one of the authors home resident
Date: 2003-11-28 at 3 pm
Length: Approx 60 minutes

Interviewee 2: Accountant at one of the main accounting firms
Place: Via telecommunication (speakerphone) at Gothenburg School of Economics and Commercial Law
Date: 2003-12-03 at 10 am
Length: Approx 60 minutes

Interviewee 3: Accountant at one of the main accounting firms (corporate finance)
Place: The interviewee's office in Gothenburg
Date: 2003-12-04 at 9 am
Length: Approx 60 minutes

Interviewee 4: Academic working with training of management and entrepreneurs in Lithuania
Place: The interviewee's office in Gothenburg
Date: 2003-12-22 at 3 pm
Length: Approx 60 minutes

Appendix 1 – Interview Guide

1. Relevant personal information about interviewee
2. With regards to accounting and financial reporting, what do you consider the main advantages and disadvantages with the former Soviet Union economical system (the planned economy)?
3. How has the old system used in the former Soviet Union influenced the way accounting and auditing are carried out to day?
4. Are there any auditing risks which you consider as being explicit to a transition economy?
5. With reference to auditing, what do you think were the main problems arising from the implementation of the new accounting system?
6. From your own experience, what do you consider being the explicit risks or problems with auditing in a transition economy?
7. When conducting an audit of a company in a transition economy, what risks do you focus on?
8. In a transition economy, which problems – not industry specific ones – would you put in the context of the following?
 - Inherent risks:
 - Control risks:
 - Detection risks:
10. Which one of the above risks do you consider to be the one in need of most caution?
11. How do you solve these problems? What precautions do you take?

Thank you very much for your time and effort that you have contributed with to our thesis.