

Accounting and Auditing**The Impact of Financial Reporting of Small and Medium Sized Enterprises in Economic Development of Balkan Countries****Artor Nuhui¹, Arbër Hoti², Lulzim Krasniqi³**

Abstract: The importance of internal and external accounting as a source of information for owners and managers of small enterprises and their different stakeholders is steadily growing. It is of crucial importance that the accounting systems applied by small enterprises meet their actual needs, providing necessary information yet avoiding unjustified administrative burden. It is recognised that appropriate accounting information is important for a successful management of a business whether it is large or small. At EU level, accounting legislation is in place for listed companies, i.e. the International Accounting Standards/International Financial Reporting Standards and for non-listed limited liability companies, the Fourth and the Seventh Company Law Directives i.e. the Accounting Directives. However, at EU level there is no accounting legislation applicable to those enterprises which are not listed or are not limited liability companies; in most cases we would be referring to small enterprises. Because of the importance of appropriate accounting information for owners and managers of small enterprises and their different stakeholders, it is considered important to analyse the various accounting systems applied in Member States in the case of non-regulation at EU level.

Keywords: Financial reporting; Small and Medium Sized Enterprises; economic growth; Balkan countries

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1. Introduction

The importance of accounting as a source of information for owners and managers of small enterprises and their different stakeholders is obvious. In the European Union (EU), there is accounting legislation in place for different kinds of companies. As regards listed companies in the EU, we have the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) as adopted by the EU (IAS Regulation (EC) N° 1606/ 2002) .

Concerning limited liability companies, there are at EU level the Fourth Directive (78/660/EEC) and the Seventh Directive (83/349/EEC) , together named the Accounting Directives, which are transposed by Member States into their national

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accounting legislation to become local GAAP (General Accepted Accounting Principles). However, there is no accounting legislation in force at EU level for those enterprises which are not covered by the IAS Regulation and the Fourth and Seventh Directives.

In 2007 the European Commission set out a vision for simplifying EU rules on company law, accounting and auditing in a Communication . In 2009 some elements of the Communication were taken forward by the Commission in a Directive amending the Accounting Directives as regards certain disclosure requirements for medium-sized companies and the obligation to draw up consolidated accounts. In 2009 the European Commission announced that micro entities would be exempted from the Accounting Directives and that in addition a modernisation and simplification of the Accounting Directives would be carried out in the near future.

In 2008 the Directorate General for Enterprise and Industry in the European Commission published an expert group report on "Accounting systems for small enterprises - recommendations and good practices" . This report describes e.g. the accounting systems and accounting framework in place for small enterprises not regulated at EU-level and identifies some good practices for these enterprises. On this account, there was obviously a need to find out more about the accounting requirements for SMEs in Europe in the future. (March 1957).

Recently, the governments of the EU Member States have agreed to extend the EU perspective to countries in South East Europe – Croatia, the Former Yugoslav Republic of Macedonia, Albania, Bosnia and Herzegovina, Montenegro and Serbia. At present, among these countries, there are only two candidates for EU membership – Croatia and FYR of Macedonia. Other countries of the region are considered as potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia). The EU integration process implies legally binding, sweeping liberalisation measures – not only capital account liberalisation, but investment by EU firms in the domestic financial services and the maintenance of a competitive domestic environment, giving this financial liberalisation process strong external incentives (and constraints).

The integration of potential candidate countries into the enlarged Europe is currently realised through Stabilization and Association Process (SAP) which aims to bring these countries progressively closer to the EU. The centerpiece of the process is a Stabilisation and Association Agreement (SAA), which represents a contractual relationship between the EU and each potential candidate country, entailing mutual rights and obligations. For each of the potential candidate countries of the Western Balkans⁴ the Commission of European Communities negotiates SAAs which have three aims: first, to encourage regional cooperation; second to promote economic stabilisation and a swift transition to a market

economy; and third to offer the prospect of EU accession. Thus, SAAs explicitly include provisions for future EU membership of the country involved. These Agreements are similar in principle to the Europe Agreements signed with the Central and Eastern European Countries (CEECs) in the 1990s.

In case of CEECs countries, the prospective EU accession served as the ultimate anchor for financial liberalisation. The EU candidate countries had to fully liberalise their financial system by the time of EU accession at the latest, as the free movement of capital is one of the leading principles of the EU. However, even if the SAAs are based mostly on the EU's *acquis communautaire* and predicated on its promulgation in the cooperation states legislation, the depth of the policy harmonisation expected by them is less that for EU member states.

Globally, the financial reporting has progressed dramatically over the past 30 years. This current wave of financial globalisation was urged by liberalisation of capital controls in many of developing countries and transition economies, in anticipation of the benefits that cross-border flows would bring in terms of better global allocation of capital and improved international risk-sharing possibilities. With the surge in financial flows, however, came a spate of currency and financial crises⁵. These developments have provoked an intense debate among both academics and policy circles on the costs and benefits of financial reporting, which has intensified and become more polarised over time. Thus, this article proposes to analyse the potential benefits and potential costs of financial reporting, which could face the potential candidate countries from Western Balkans during integration of their financial systems into the European financial system, as well as into the world financial markets.

2. Financial Sector Restructuring in the Western Balkans

Analytically, any financial system can be divided in three sub-sectors: the banking sector (regrouping the commercial or deposits banks), the non-banking financial institutions (like savings-institutions, insurance companies, private pension funds, mutual funds societies, investment funds,...) and capital (or financial) markets. Banks act as credit-suppliers from the deposits they collect and funds they borrow from the Central Bank; such specific financing facility is not available to the non-banking institutions. In the majority of transition economies, the role of non-banking institutions in mobilisation and allocation of financial resources was and remained quite negligible during the 1990s, and the same appears in Western Balkans countries, where the banking sector continues to dominate the financial system, managing for over 90% of total financial assets, while capital markets and non-banking financial institutions play only marginal roles (Müller-Jentsch, 2007).

However, the financial sector in the Western Balkans has improved significantly in

recent years and a deep restructuring process has been (and proceeds to be) implemented. This owes to comprehensive reforms by governments and the support of international financial institutions like the IMF, the World Bank, and the EBRD. However, fifteen years ago, financial markets in former Yugoslavia and in Albania were poorly developed. The break-up of Yugoslavia led to the fragmentation of financial services companies, the establishment of new regulatory institutions and a freezing of foreign currency deposits. During the 1990s, pyramid saving schemes in Albania, hyperinflation in Serbia and Montenegro, the wars in Bosnia and Kosovo as well as banking crises in several countries of the region weakened the financial sector. Macroeconomic disturbances, a weak rule of law, a large stock of bad debt and low capitalisation rates further undermined the stability of financial markets.

The inefficiency in the financial sector was also influenced by its underdeveloped structure. It was characterised by domination of the banking sector, while the role of non-banking sector in mobilisation, concentration and allocation of financial resources was almost non-existent. In addition, the majority of banks were insolvent and unable to fulfil the requirements established by prudential norms while the banking balances were burdened by a high level of risky and non-performing loans (Goluboviæ and Goluboviæ, 2005).

As the consequence, the policy agenda during the late 1990s and early 2000s was dominated by efforts to clean up and stabilise the banking industry. Regulatory frameworks have been modernised and financial supervision has been strengthened. The share of bad loans has been reduced dramatically. Privatisation has helped to reduce state ownership in banking down to less than 20 percent in most countries and has attracted foreign banks into the market.

Despite these positive developments cited above, financial markets in the Western Balkans remain small, fragmented, and at an early stage of their development. The general characteristics of this market are: activity on the equity market is considerably lower than activity of the banking sector; majority of the countries are characterised by low liquidity on the capital market, with exchange concentrated on small number of shares of listed companies; and, an increased sensitivity of the financial markets to the movements of speculative capital (S. Goluboviæ and N. Goluboviæ, 2005).

Western Balkan banking sector has recently attracted considerable attention from foreign investors through a removal of national restrictions, the liberalisation of market access, and the sale of stateowned banks. The transition process from plan to market economy has proved to be an opportunity for many foreign banks to expand their activities to countries of the region. In the early years of transition, many EU banks set up small representative offices in the Western Balkans in order to serve their home clients who were entering the region. As cross-border linkages

became more familiar with local conditions, they gradually expanded their presence in the region. Now some of them have established branch networks throughout the region and act as “universal banks” that offer a broad range of financial services.

It is notable that the majority foreign-owned banks still retain the highest share of the total assets of the banking system in the region. In 2007, banks with majority of foreign capital, controlled approximately 75% of banking market of Albania, Bosnia and Herzegovina, Montenegro and Serbia. In 2005- 2007, the market share of foreign banks stood at around 90% in Albania. Banks with majority of foreign capital controlled 86.1% of Bosnia and Herzegovina banking market in 2005, 90.3% in 2006 and 91% in 2007. In Serbia, it increased from 37% in 2005 to 75.5% in 2007, due to privatisation and organic growth of the subsidiaries of EU banks. Share of foreign capital, in Montenegrin banking sector, was around 78.8% by the end of 2006.

Owners include international banking groups coming primarily from EU countries (such as Austria, Italy, Greece, France, etc.). Austrian and Italian banks in particular operate across the Western Balkans. For instance, the Austrian investors are dominant in Bosnia and Herzegovina (59% of banking assets in 2007) and in Albania (55% of banking sector in 2005). Greek banks have also entered the region; by mid 2005, they had invested around EUR 750 million in the Western Balkans, half of which in Serbia alone. Since the start of financial system reform, these groups introduced numerous positive changes in the region, improving the performances of the domestic banking sector and providing stable foreign sources of financing domestic credit expansion.

Thus, the process of financial reporting of the Western Balkans has primarily been driven by foreign direct investments (FDI) of EU banks into domestic banking sector. These strategic investors have been a way to strengthen the banking system in the region and to improve the low level of financial intermediation. They brought with them technical know-how, such as modern risk-management and marketing techniques. They tend to raise governance standards, introduce new financial products. They come with the resources to re-capitalise domestic banks and modernise branch networks. Moreover, FDI from the EU also helps the Western Balkan countries to “import” modern prudential regulation from EU. However, there are also some concerns about the growing influence of foreign banks in these regional banking markets. These, mainly, relate to the possibility that foreign banks turn out to be instable sources of bank credit, especially during financial crises or during economic downturns (either in Western Balkan countries or in their home markets).

3. Financial Reporting, Its Potential Benefits and Costs

The IFRS for SMEs is a self-contained standard of 230 pages, designed to meet the needs and capabilities of small and medium-sized entities (SMEs), which are estimated to account for over 95 per cent of all companies around the world.

Because full IFRSs were designed to meet the needs of equity investors in companies in public capital markets, they cover a wide range of issues, contain a sizeable amount of implementation guidance and include disclosures appropriate for public companies. Users of the financial statements of SMEs do not have those needs, but, rather are more focused on assessing shorter-term cash flows, liquidity and solvency. Also, many SMEs say that full IFRSs impose a burden on them — a burden that has been growing as IFRSs have become more detailed and more countries have begun to use them. Thus, in developing the proposed IFRS for SMEs, IASB's twin goals were to meet user needs while balancing costs and benefits from a preparer perspective.

The IFRS for SMEs responds to strong international demand from both developed and emerging economies for a rigorous and common set of accounting standards for smaller and medium-sized businesses that is much simpler than full IFRSs. In particular, the IFRS for SMEs will:

- provide improved comparability for users of accounts;
- enhance the overall confidence in the accounts of SMEs, and
- reduce the significant costs involved of maintaining standards on a national basis.

The IFRS for SMEs will also provide a platform for growing businesses that are preparing to enter public capital markets, where application of full IFRSs is required.

The IFRS for SMEs is separate from full IFRSs and is therefore available for any jurisdiction to adopt whether or not it has adopted the full IFRSs. It is also for each jurisdiction to determine which entities should use the standard. It is effective immediately on issue.

In developing the IFRS for SMEs the IASB consulted extensively worldwide. A 40-member Working Group of SME experts advised the IASB on the structure and content of the IFRS at various stages in its development. The exposure draft of the IFRS, published in 2007, was translated into five languages to assist SMEs in responding to the proposals. More than 50 round-table meetings and seminars were held to receive direct feedback, and the draft IFRS was field-tested by over 100 small companies in 20 countries. As a result, further simplifications have been achieved in the final document.

4. Potential Benefits of Financial Globalisation in Theory

In small enterprises there can be different kinds of accounting systems such as external, internal and tax accounting. Annex 3 summarises data per Member State concerning accounting system requirements for small enterprises. On the basis of this data, the following descriptions of accounting systems are given:

Internal accounting, also called management accounting is based on the enterprise's internal accounting procedures and recorded accounting information. Internal accounting is intended for managers within organizations, to provide them with the economic basis to make informed business decisions that would allow them to be better equipped in their management and control functions. For example, managers may want to be able to assess the contribution or the profitability of different products or services that they supply by comparing the revenues and costs that they generate. Unlike external accounting information, internal accounting is usually confidential and it is accessible only to the management. In most cases, small enterprises do not use internal accounting at all due to their size. Internal accounting is normally not governed by national legislation. However, in some Member States internal accounting is compulsory even for small enterprises.

External accounting, also called financial accounting is concerned with the preparation of financial statements for decision makers, such as the owners, suppliers, banks, governments and its agencies, customers and other stakeholders outside the enterprise. Regarding formats for financial statements see chapter 7. External accounting makes use of the accounting information from the internal accounting system. In the preparation of the external accounting, the small enterprise may be governed by local

GAAP. Some Member States have introduced external accounting rules for small enterprises, while others have no accounting rules in place and leave it to the enterprises themselves to decide which accounting systems they consider to be appropriate for their particular circumstances and business environment.

Tax accounting is normally based on the external/financial accounting system. There may be differences between the profits for tax purposes and the profits per the accounts. Tax authorities often ask for additional adjustments to be made to the profits per the accounts and these are captured in a "tax computation". Some examples of adjustments which are quite common between profits per accounts and tax profits:

- Depreciation differences
- Accruals
- Expenses which are disallowed for tax purposes
- Non-taxable income

In some Member States, taxation is carried out on a cash basis accounting system, in which case further adjustments (when the enterprise uses accrual basis accounting) like accruals, unrealised income and unrealised expenses are to be made to the enterprise's results before the tax computation.

Since the financial sector in the Western Balkans is bank-dominated, it seems important, for us, to pay more attention to the benefits that can bring foreign participation in the local bank sector. Theoretically, foreign bank participation can generate a variety of benefits (Levine, 1997, 2005). First, foreign bank participation can facilitate access to international financial markets. Second, it can help improve the regulatory and supervisory frameworks of the domestic banking sector. Third, it can improve the quality of loans, as the influence of the government on the financial sector should decline in more open economies. Fourth, in practice, foreign banks may introduce a variety of new financial instruments and techniques and also foster technological improvements in domestic markets. Fifth, the entry of foreign banks tends to increase competition, which, in turn, can improve the quality of domestic financial services as well as allocative efficiency. Sixth, the presence of foreign banks can also provide a safety valve when depositors become worried about the solvency of domestic banks. Finally, foreign banks entry enhances legislative framework, financial monitoring, reduces corruption and stimulates the development of transparent intermediary operations (De Haas and Van Lelyveld, 2003).

Even if theoretical models have identified a number of channels through which international financial reporting can help to promote economic growth, and on the surface, there seems to be a positive association between embracing financial globalisation and the level of economic development¹¹, it is quite difficult to empirically identify a strong and robust causal relationship between financial reporting and growth, especially for developing countries (Eichengreen, 2000; Prasad and al., 2003). Besides, many of empirical papers have often found mixed results, suggesting that the benefits are not straightforward.

One of the reasons for the lack of consensus can be ascribed to the difficulty in properly measuring the extent of financial reporting (Chinn and Ito, 2007). Although many measures exist to describe the extent and intensity of capital account controls, it is generally agreed that such measures fail to capture fully the complexity of real-world capital controls for a number of reasons¹². In fact, we can distinguish three main measures of the extent of financial reporting: de jure measures (that capture the legal restrictions on cross-border capital flows based on data from IMF's AREAER¹³); de facto measures which includes the price-based measures (CIP, UIP and RIP¹⁴) and the quantitybased measures (based on actual flows); another de facto measure of financial reporting is savinginvestment correlation (Feldstein and Horioka, 1980). Apparently, the distinction between de jure and de facto integration appears to matter a great deal in understanding the

macroeconomic implications of financial globalisation. The basic problem with *de jure* measures is that implementation and enforcement differ so greatly across countries that international comparisons are doubtful. Consequently, even if most empirical papers analysing the effects of financial reporting rely on *de jure* measures, *de facto* integration measures may be more appropriate for analysing the direct and indirect benefits of financial reporting.

An alternative line of inquiry into the effects of financial globalisation is based on the notion that not all capital flows are equal. Flows like Foreign Direct Investment (FDI) and, perhaps, international portfolio flows are not only presumed to be more stable and less prone to reversals (Wei, 2006), but are also believed to bring with them many of the indirect benefits of financial globalisation such as transfers of managerial and technological expertise. Thus, the composition of capital inflows can have an important influence on the benefits of financial reporting for developing countries as well as for transition countries.

Finally, it seems that it is not just the capital inflows themselves, but what comes along with the capital inflows that drive the benefits of financial reporting for developing and transition countries (Kose and al., 2006). There is considerable evidence that financial reporting serves as an important catalyser for a number of indirect benefits, which M. Kose and al. (2006) name potential “collateral benefits” since they may not generally be the primary motivations for countries to undertake financial reporting. They could include development of the domestic financial sector, improvements in institutions (defined broadly to include governance, the rule of law, etc.), better macroeconomic policies, etc. These collateral benefits then result in higher growth, usually through gains in allocative efficiency.

The accounting framework lays down the concepts and principles that are the basis for preparing and presenting the external financial statements of an enterprise. These principles may not necessarily be applicable in all Member States to all enterprises all the time because of e.g. the size of the enterprise or different user’s needs. Therefore, each enterprise needs to decide which principles it considers most important and applicable to its particular circumstances and business environment. (Kose and al., 2006).

5. Potential Costs of Financial Reporting

In spite of its beneficial effects, financial reporting can also be dangerous, as it has been witnessed in many past and recent financial, currency and banking crises. It can make countries more vulnerable to exogenous shocks. In particular, if serious macroeconomics imbalances exist in a recipient country, and if the financial sector is weak, be it in terms of risk management, prudential regulation and supervision,

large capital flows can easily lead to serious financial, banking or currency consequences.

In fact, the experience of the past three decades has led economists and policy makers to recognize that, in addition to the potential benefits discussed above, open financial markets may also generate significant costs. Such potential costs include a high degree of concentration of capital flows and a lack of access to financing for small countries (either permanently or when they need it most); an inadequate domestic allocation of these flows (which may hamper their growth effects and exacerbate pre-existing domestic distortions); a loss of macroeconomic stability; a pro-cyclical nature of shortterm capital flows and the risk of abrupt reversals; a high degree of volatility of capital flows (which relates in part to herding and contagion effects); and risks associated with foreign bank penetration (Agénor, 2001).

Again, since financial sector of Western Balkan countries is bank-dominated, we would like to point out the potential “danger” of presence of foreign bank on the domestic financial sector. Although foreign bank penetration can yield several types of benefits (as discussed earlier), it also has some potential disadvantages as well.

First, foreign banks may ration credit to small firms to a larger extent than domestic banks, and concentrate instead on larger and stronger ones. If foreign banks concentrate their lending operations only to the most creditworthy corporate borrowers, their presence will be less likely to contribute to an overall increase in efficiency in the financial sector. More importantly, by leading to a higher degree of credit rationing to small firms, they may have an adverse effect on output, employment, and income distribution (Agénor, 2001).

Second, entry of foreign banks, which tend to have lower operational costs, can create pressures on local banks to merge in order to remain competitive. Furthermore, the process of concentration (which could also occur as foreign banks acquire domestic banks) could create “too big to fail” banks. A too-big-to-fail problem may, in turn, increase moral hazard problems: knowing the existence of an (implicit) safety net, domestic banks may be less careful in allocating credit and screening potential borrowers (Agénor, 2001). Concentration could also create monopoly power that would reduce the overall efficiency of the banking system and the availability of credit. In particular, a high degree of banking system concentration may adversely affect output and growth by yielding both higher interest rate spreads (with higher loan rates and lower deposit rates relative to competitive credit and deposit markets) and a lower amount of loans than in a less concentrated more competitive system.

Third, entry of foreign banks may not lead to enhanced stability of the domestic banking system, because their presence per se does not make systemic banking

crises less likely to occur – as it may happen if the economy undergoes a deep and prolonged recession, leading to a massive increase in default rates and an across-the-board increase in non-performing loans, and because they may have a tendency to "cut and run" during a crisis (Agénor, 2001).

6. Conclusions

Small enterprises may use simplified formats for financial statements i.e. for the balance sheet and the profit and loss account. Depending on the business environment in which the enterprise operates, it can choose the format of the profit and loss account i.e. by nature or by function. Normally the financial statements would be prepared once a year when the tax declaration has to be provided.

A projected cash flow statement can be very useful for small enterprises because the cash management of a small enterprise is especially important. Cash flow projections are partly based on information from the accounting systems of the enterprise. Cash management becomes especially important in situations when the economy is heading for a downturn.

To help speed up and professionalize negotiating loans, it is useful to agree on binding standards about form and contents of information provided between SME-organizations and banks. Small enterprises and banks gain transparency about the scope and the quality of the information. The bank guarantees a decision within a short period. (e.g. 10 days).

The SME-organization may offer support to the small enterprise in the preparation of the records and the negotiations

The accounting systems in place for small enterprises in Member States vary a lot. There are cases when there are no accounting requirements at all and cases where the accounting requirements are relatively strict for small enterprises. However, in practical terms, all small enterprises will need to keep some kind of financial records in order to keep financial control over their businesses. This report summarises the likely accounting systems from the point of view of small enterprises in Member States and identifies some good practices on how to improve the accounting systems for small enterprises.

The objective of this report is to provide views on how to improve the accounting systems so that they can provide the owners/managers of the small enterprises with appropriate financial information. The aim is not to add to regulation but to identify good practices which small enterprises may consider before deciding on an appropriate accounting system. However, these recommendations are in no way intended to encroach upon the sovereignty of Member States in accounting matters.

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