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FINANCIAL REPORTING IN POLAND: PRIVATIZATION
OF SELECT FIRMS TRADED ON THE
WARSAW STOCK EXCHANGE

DISSERTATION

Presented to the Graduate Council of the
University of North Texas in Partial
Fulfillment of the Requirements

For the Degree of

DOCTOR OF PHILOSOPHY

By

Denise M. de la Rosa, B.A., M.A., M.Acc.

Denton, Texas

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Poland's transition from a centrally-planned economy (CPE) to a market economy began in 1989. Building a market economy out of the failures of a CPE represents an unprecedented process in the history of economic development. At the core of the transition is the privatization of state-owned enterprises (SOEs). Many problems encountered during privatization are accounting related, and before privatization can occur valuation issues must be resolved.

What has been the role of accounting in Poland's transition? Accounting is an interactive process that reflects and creates reality. The accounting process facilitates the calculation of the value created by a firm by attempting to trace the flow of resources through the value-creating process, and it identifies, measures, records, summarizes, and reports transactions. How these transactions are internalized determines how they flow through the accounting process, and, because the former SOEs are complex organizations in transition, decisions concerning when and how to record events can be diverse.

The primary objective of this study is to provide insight into the accounting transition in Poland by addressing issues of ownership rights, valuation, financial reporting, and disclosure. The research question is: How is accounting transforming and being transformed in Poland? The research question is addressed in the context of the political and economic environment of three SOEs privatized and traded on the Warsaw Stock Exchange.

To identify the role accounting played, I examined the financial reports of three of the first Polish SOEs privatized, employing case study methodology. The analysis indicates that accounting facilitated the transition by creating capital with the overstatement of assets. The overvalued assets will have to be absorbed in future periods, and subsequent research should address this problem.

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CHAPTER 1

INTRODUCTION

Research Problem

Eastern Europe's transition from centrally-planned economies to market economies began in 1989. Farrell (1991) explains that this transition, building a market economy out of the failures of a centrally-planned economy (CPE), represents an unprecedented process in the history of economic development. The incompatibility of the two systems makes the change arduous because only the starting point can be defined. The intermediary steps and their impact on the economic and sociopolitical fabric of society cannot be ascertained in advance. Although some political scientists and economists have long suggested a convergence hypothesis between capitalism and communism (Gregory and Stuart 1985), the extant structures of the countries in transition suggest otherwise. Farrell (1991) states that the convergence hypothesis has credence only if the collapse of CPEs is considered as a form of convergence.

At the core of the transition is the privatization of state-owned enterprises (SOEs). The United Nations Commission on Transnational Corporations has identified many of the problems that have been encountered when an attempt is made to transfer public assets to private individuals.

The report states that the preponderance of problems are accounting related. Valuation and transferability of ownership are central to the discussion of privatization and arise "because new accounting systems are imposed on old ones and/or the quality of the data is insufficient to produce useful information" (United Nations 1992).

Koslowski (1992) suggests that the issues are more complex than simply valuation and transferability of ownership. The shock therapy that has been advocated by the International Monetary Fund (IMF) and the World Bank is based on the universal applicability of neoclassical economics in capitalist economies. In terms of privatization, Koslowski (1992) posits that neoclassical analysis is unable to adequately deal with Eastern Europe's reform because the issue does not simply center on the transfer of public property to private property. Privatization in Eastern Europe is a two-step process: Before privatization can occur, the communal system must be transformed to a public system (Comisso 1991).

Research Question

What has been the role of accounting in the transition? Accounting is an interactive process that reflects and creates reality (Berger and Luckman 1966; Hines 1988). As an information system, accounting provides the basis for measurement and reporting of an organization's activities. Accountants employ various techniques to measure the costs

of products. The accounting process facilitates the calculation of the value created by a firm by attempting to trace the flow of resources through the value-creating process, and it identifies, measures, records, summarizes, and reports transactions. How these transactions are internalized determines how they flow through the accounting process, and because the former SOEs are complex organizations in transition, decisions on when and how to record events can be diverse.

The primary objective of this study is to provide some insight into the accounting transition occurring in Poland by addressing issues of financial reporting and disclosure. The principal research question is twofold: How is accounting transforming and being transformed in Poland? Ancillary to this question are the following: (1) What role is accounting playing in the transformation process? and (2) How has accounting been used to facilitate the transition? Using an exploratory case study approach based on Kaplan's pattern model and developments in international accounting research, the preceding questions are addressed in the context of three of the SOEs privatized and traded on the Warsaw Stock Exchange.

The Pattern Model

Kaplan (1964) posits that the domain of truth has no fixed or established boundaries. "Each discipline may take from others techniques, concepts, laws, data, models,

theories, or explanations . . . whatever it finds useful in its own inquiries" (Kaplan 1964, 4). Kaplan (1964) refuses to define a "scientific method" because he believes that a definition would inhibit inquiry. A definition that is specific enough to embrace a methodology "is not sufficiently general to embrace all the procedures that scientists may eventually come to find useful" (Kaplan 1964, 27).

Kaplan (1964) suggests the pattern model as one basis for scientific inquiry. The pattern model encompasses description, explanation, and interpretation. While descriptions tell us what happened, explanations tell us why an event occurred. Because explanations may have both a semantic and a scientific component, interpretations reflect the manifestations of this duality. Semantic explanations are symbolic translations of words, acts, and actions; they are meanings. Scientific explanations, on the other hand, provide more than symbolic meanings or descriptions. A scientific explanation "tells us something else than the mere description of what it is explaining, and especially something appropriate to the context in which the explanation is to function" (Kaplan 1964, 329).

The pattern model is based on explanations, or as Kaplan (1964) posits, concatenated descriptions. Facts are linked together in some common focus. Only then can this concatenation shed light on the subject under investigation

and elucidate something that is intelligible and understandable. Understanding is knowing the reason why, and "we know the reason for something either when we can fit it into a known pattern, or else when we can deduce it from other known truths" (Kaplan 1964, 332). In other words, Kaplan (1964) believes that scientific inquiry can be approached in two ways, using a pattern model of explanation or a deductive model. While the deductive model is suitable in the later stages of scientific inquiry, the pattern model is appropriate when explanations are sought in the early stages of inquiry. Because the subject of this study deals with the unprecedented transition in Poland from a CPE to a market system, the pattern model provides the most appropriate method of analysis.

The pattern model is a methodology for discovering relationships. Since the requirements for Polish accounting necessitate developing new, dynamic, and changing relationships based on a micro-orientation rather than the prior macro one, the pattern model facilitates inquiry. Explanations remain open because their attributes allow them to be only partial, conditional, approximate, indeterminate, inconclusive, uncertain, intermediate, and limited. Kaplan (1964) contends that the history of science is replete with instances whereby subsequent explanations replace earlier accounts. He maintains that "even the paradigmatic science of celestial mechanics, when it is applied to particular

cases, exhibits this incompleteness--or if not the science, then surely our knowledge of the specific circumstances" (Kaplan 1964, 351).

To meet the requirement of scientific inquiry, explanations must rest on considerable evidence, although in the future they may be proven to be false. However, explanations can never be truly false. Rejection of an explanation occurs when there is a shift in the weight of subsequent evidence. Therefore, acceptable explanations need not be an accumulation of immutable and absolute truths.

What has happened is that we have found something which serves the ends of inquiry at a particular time and place; we have gotten hold of an idea which we can do something with--not to set our minds at rest but to turn their restlessness into productive channels. Explanations do not provide us with something over and above what we can put to some use. (Kaplan 1964, 355)

Extensive support for Kaplan's approach to scientific inquiry exists in institutional economics. Institutionalists embrace a holistic approach that systematically examines patterns (Radzicki 1988; Wilber and Harrison 1978; Wisman and Rozansky 1991). Wilber and Harrison (1978) posit that institutionalists have long recognized that formal methods do not explain social reality. Adaptation of Kaplan's pattern model (a systematic form of storytelling) allows the institutionalist the ability to view the economic system as a process of social change, a product of human action that is shaped within its

contextual environment. The operational lens that Wilber and Harrison (1978) use views the economy as an evolving, dynamic whole rather than as an atomistically segregated and static entity.

Institutionalism is holistic because it focuses on the pattern of relations among parts and the whole. It is systematic because it believes that those parts make up a coherent whole and can be understood only in terms of the whole. It is evolutionary because changes in the pattern of relations are seen as the very essence of social reality. (Wilber and Harrison 1978, 71)

Wisman and Rozansky (1991) suggest that an institutional approach based on the pattern model is capable of providing a framework for analysis that considers the relative temporary nature of relationships. Because of the nature of social reality, the subject matter is viewed as transtemporal and transspatial. Formal theories of capitalism are limited in their explanatory power. For example, a formal theory that explains United States capitalism will be inadequate when applied to Japanese capitalism.¹ Any regularities may be simply relative to time and place, capturing what Wisman and Rozansky (1991) label as local regularities.

Formal theories of accounting that are transtemporal, transspatial and transcultural appear inappropriate in post-communist countries. Capital market research that applies

¹See Abercrombie, Hill, and Turner (1986) for a sociological view of communal capitalism in Japan and how it differs from industrialistic capitalism in the Anglo-American world.

current methods to prior periods attempts to impute a current interpretation of what the expected behavior for a rational person is at a given historical period rather than what was possible given the historical context (Merino, Koch, and MacRitchie 1987; Previts and Bricker 1993). Merino, Koch, and MacRitchie (1987) explain that the analysis of any event is interactive and requires a sequential analysis that incorporates an investigation of subsequent events. Impairment of construct validity occurs when period-specific issues are ignored (Previts and Bricker 1993).

Wisman and Rozansky (1991) suggest that any method of inquiry is contingent upon the subject matter. When the subject matter exhibits a significant degree of transhistorical and transcultural consistencies, then a methodology that allows for a structured, formal approach is suitable; however, when there is a lack of regularities and consistencies, then a logically deductive structure becomes inappropriate. A more suitable strategy incorporates an analysis that is flexible, fact-based, and non-dogmatic (Petr 1987).

This study adopts Kaplan's pattern model as a basis for examining the emergent social reality of an interactive accounting process integrated within the dynamically changing legal, sociopolitical, and economic fabric of Polish society. The analysis incorporates description,

explanation, and interpretation based on the duality of explanations (semantic and scientific).

International Accounting Research

The magnitude of international accounting is all-encompassing, including issues such as managerial and financial accounting, taxation, auditing, currency translation, harmonization/standardization, financial statement restatements, foreign direct investment, and internationalization of financial markets. The subsequent literature review addresses issues relating to financial reporting, disclosure, and economic development. International accounting is not a separate discipline.² It encompasses all aspects of accounting of a transnational character, either from the perspective of the researcher or from the activity of organizational bodies and corporations.

Issues in international accounting are strongly influenced by national cultural values. These values permeate the organizational and subcultural levels of

²In one of the earlier treatises on international accounting, Mueller (1967, ix and 1) calls his book "an introduction to the international dimensions of accounting" and refers to the study of international accounting as "the study of national or regional patterns of development ... different environments have produced different results in accounting structures." Mueller's discussion of patterns, however, is restrictive. He delineates only four: (1) a macroeconomic pattern, (2) a microeconomic pattern, (3) an independent discipline approach similar to the UK and US systems, and (4) a uniform approach. This classification is purely judgmental, and there seems to be some overlap with Germany, which features both a uniform and macroeconomic approach (Meek and Saudagaran 1990).

society and inevitably formulate the accounting system based on the culture's needs and concerns. In order to minimize the methodological problems of cross-cultural research, accounting must be studied in the context in which it operates (Gray and Roberts 1991). Gray (1989, 291) proposes "a global environmental and cultural framework . . . as a basis for identifying international forces at the national level." He suggests that individual cultures must be studied when comparing international issues. The forces for change at work among nations and societies are a result of cultural patterns developed over time.

Gray (1988, 1989) suggests that accounting researchers need to follow Hofstede's (1980) framework for the development and maintenance of culture. Gray (1989) proposes a framework that presents an interactive accounting process. Society's origins influence societal values, which in turn influence family patterns, social class structure, political system, business ownership and organization, and the education system. These relationships are dynamic. The pattern of change also can be influenced by external forces of nature as well as by the intentional actions of people.

Gray (1989) extends and adapts Hofstede's (1980) model by suggesting a framework for international accounting change and development. Assuming that cultural and societal values are determinants of a country's organizations, then accounting systems and practices are influenced and

reinforced by societal values interactively. This interactive aspect produces accounting values that affect changes in societal values that are reflected in financial reporting and disclosure requirements.

Gray (1988) posits that the orientation of financial statements across countries varies. The influence of tax law can explain part of the difference; however, the orientation toward different groups of users is an important factor. The emphasis in the UK is on equity investors who are primarily interested in profits available for distribution, whereas the orientation in France and Germany appears to be toward creditors and debt financiers who are more concerned about the firm's ability to pay interest. The difference in emphasis produces distinctive financial reporting variants.

In a global world, interconnected and more closely linked in terms of economic, political, and cultural influences, international forces for change are powerful, indirect determinants of accounting systems. There is no methodology that can adequately account for global, national, societal, and individual impacts on accounting issues. Gray (1989, 305) argues that "international accounting research should be problem driven rather than methodology driven if it is to be relevant." But Mandelbaum (1977) warns that specialized disciplines, such as accounting, are subject to cultural importation. Thus, the

task of identifying the sources of change may be more complex than suggested by Gray (1989, 1988). For example, Poland has imported European Community (EC) standards that may be inconsistent with its existing sociocultural structure. The pattern model facilitates identification of cultural importation by isolating local regularities while simultaneously recognizing that all explanations require subsequent interpretation.

Most of the literature on international financial accounting is descriptive, focusing on the individual financial reporting and accounting practices of various nations (Meek and Saudagaran 1990; Wallace and Gernon 1991). Meek and Saudagaran (1990) suggest that descriptive studies continue to be prevalent because of the dynamic nature of financial accounting, and, for this reason, they warn against the reliance on dated surveys. They stress the need to analyze original documents and country-specific sources with the understanding that a country's official pronouncements regarding reporting standards and requirements may differ from actual reporting practices used by business firms within the country. This may be especially true in Poland, where standards have been legally codified to meet demands of the IMF, the EC, and the World Bank.

Much of the descriptive work in international accounting focuses on the industrialized Western countries.

The scope of this work needs to be expanded to include more descriptive research on both the former socialist economies as well as developing economies. The Meek and Saudagaran (1990) study is a survey of international financial reporting research, which they categorize into four distinct classifications.³ The first category encompasses country studies and research that attempt to determine the variables that influence accounting systems and development. Individual country studies as well as comparative studies of two or more nations make up this category.⁴ There is a need in the accounting literature for nation-specific research that expands our knowledge of the world.

Understanding the rationale underlying accounting requirements in specific countries provides a better appreciation of why differences in accounting requirements exist across countries. (Meek and Saudagaran 1990, 152)

Other studies within this classification attempt to develop theories regarding the extent that environmental factors influence accounting principles, systems, and development. There seems to be substantial agreement and

³Although Wallace and Gernon (1991) make a distinction between what they term international issues, Meek and Saudagaran (1990) use the terms international, global, and transnational interchangeably.

⁴Some of the studies found in this category include Bailey (1982), Bloom and Naciri (1989), Choi (1982), Choi and Hiramatsu (1987), Choi et al. (1983), Enthoven (1985), Gray et al. (1984), Gray and Radebaugh (1984), Lebow and Tondkar (1986), Lev (1976), McKinnon and Harrison (1985), McNally et al. (1982), Nobes and Parker (1991), and Zhou (1988).

support in the literature for the following five environmental factors: (1) legal system, (2) characteristics of the relationship between business enterprises and their sources of capital, (3) tax laws, (4) inflation levels, and (5) political and economic connections. In another, more comprehensive list of relevant environmental circumstances contributing to the development of accounting (see table 1), Choi and Mueller (1978, 23) specify fifteen factors and explain that "both the process of searching for them and the circumstance themselves are rather subjective and therefore defy statistical specifications."

The second category in the typology of international accounting research embraces studies that attempt to classify financial accounting and reporting systems. Researchers search for common and distinctive elements in the financial accounting systems of a group of nations. Use of cluster analysis aids the identification of similarities and differences in hopes of facilitating an understanding of transnational accounting; however, this avenue of research, in general, has produced inconsistent and incongruous results, perhaps reflecting the cultural importation that occurs in developing countries.

Meek and Saudagaran's (1990) third category encompasses mostly empirical studies that examine transnational financial reporting practices. These studies utilize financial statement information from companies listed on

TABLE 1
RELEVANT ENVIRONMENTAL FACTORS

1	Type of economy involved
2	Legal system
3	Political system
4	Nature of business ownership
5	Differences in size and complexity of business firms
6	Social climate
7	Relative stability of the currency
8	Level of sophistication of management and the financial community
9	Degree of legislative business interference
10	Presence of specific accounting legislation
11	Speed of business innovations
12	Stage of economic development
13	Growth patterns of an economy
14	Status of professional education and organization
15	General levels of education

Source: F. Choi and G. Mueller, An Introduction to Multinational Accounting (Englewood Cliffs, NJ: 1978), 23-28.

major stock exchanges in highly developed economies. Issues such as statement translations and restatements, geographical segmentation, and voluntary versus non-voluntary disclosures are explored by employing readily available databases with sophisticated statistical techniques that often appear to be too advanced for the question addressed.

Choi et al. (1983) restate the financial statements of a sample of South Korean and Japanese companies and conclude that accounting numbers have little significance in and of themselves. The authors demonstrate that institutional, cultural, political, and tax considerations in Japan and South Korea affect their accounting ratios differently than those used in United States measurement norms. This difference is country-specific and may not necessarily impact financial risk and stock return in the same way that it does in the United States. The consequences of accounting numbers depend on an understanding of the environmental context from which they are generated.

The measurement and disclosure principles that constitute the basis of financial reporting have remained typically nationalistic. Choi and Levich (1990) suggest that differences in financial measures of firm risk and return characteristics could just as easily be a result of real differences in the attributes being measured as differences in accounting measurement rules. They further propose that, if accounting measurement disparities were simply the difference among each country's rules, then straightforward transformations would produce unambiguous reports that would be understandable by all. This, however, is not the case since cultural, economic, and institutional differences create barriers to strict transformation.

Based on the paradigm that accounting rules should be consistent with the environmental norms--economic,

cultural, institutional--national accounting rules would be similar only to the extent that environmental systems (including tax policy, fiscal policy, regulatory objectives, managerial systems, performance incentives, and other cultural factors) were broadly similar across countries. The diversity in the manufacturing and service corporate sectors as seen against the backdrop of diverse national economic, cultural and institutional settings begs the question of whether the necessary conditions are in place to recommend a uniform international accounting system. (Choi and Levich 1990, 7)

There are significant measurement differences between countries. Areas of differences in practice include consolidations, business combinations, deferred taxes, pensions, goodwill, leases, and foreign currency translations. The level of required disclosures also differs among countries; dissimilarities also exist in audit report requirements. The audit scope, auditor qualifications, and auditing procedures, accompanied by varying auditing standards, contribute to the disparities among countries. Meek and Saudagaran (1990) posit that if indeed accounting develops as a result of local needs and parameters, then efforts at accounting harmonization are doomed to failure unless they take into consideration the variables that produce the variation in the first place.

An outgrowth of transnational reporting is the fourth classification in the Meek and Saudagaran (1990) typology-- international accounting harmonization. These studies examine the role of international standards and cross-border interests of multinational corporations (Hussein 1992; Purvis et al. 1991; Tay and Parker 1990).

Wallace and Gernon (1991) proffer a framework similar to that of Meek and Saudagaran (1990) but posit that, when studies in international comparative financial accounting research (ICFAR) advance beyond the descriptive, forthcoming explanations do little to foster an all-encompassing theory of how and why accounting systems differ from country to country.⁵ Wallace and Gernon (1991) try to proceed beyond the framework and address methodological issues. The authors ask the question: "What is wrong with the current methodology?" (Wallace and Gernon 1991, 215). First, they conclude that too much emphasis is placed on accounting as a technical discipline. Methodological improvement can be achieved by viewing accounting as a linguistic, economic, sociological, and political phenomenon. Table 2 provides a list of the various perspectives suggested by Wallace and Gernon (1991). The second methodological weakness that plagues ICFAR is the critical distance between the researcher and data onslaught (Wallace and Gernon 1991). The authors suggest that the researcher adopt a neutral

⁵Wallace and Gernon (1991, 210) make a distinction between international accounting and ICFAR in their study. They define international accounting as the discipline that explores accounting problems within a world system. Issues related to the International Accounting Standards Committee and viewpoints of transnational corporations interpreted from its headquarters comprise two areas of concern in international accounting. ICFAR, on the other hand, is the "study of accounting practices in various countries and socioeconomic systems for the purpose of providing explanations for the similarities and differences identified and developing and testing universal accounting theories."

position toward the subject and search for links between accounting and society.⁶ The accumulation of staggering amounts of data and descriptions that do not go beyond simple descriptions restricts the development of ICFAR. Wallace and Gernon (1991, 221) posit that the researcher of ICFAR must "examine and compare both differences of degree and differences in relation to trait patterns." In order to understand a national accounting system as a dynamic and ongoing process, the researcher must be able to discern the patterns of change rather than the staticism of any one particular period. Furthermore, Wallace and Gernon (1991, 222) suggest that "one must understand that a nation is not just an object, but a subject with a peculiar cultural characteristic that is inseparable from its being that kind of nation."

The evidence that cultural, institutional, economic, and political differences exist across countries is

⁶The search for links between accounting and society is appropriate; however, adoption of a value-neutral perspective is not possible. Dore (1983) paints a picture of contracting in Japan as obligated relational contracting in which a give-and-take attitude prevails. The basic assumptions of positive accounting theory which are grounded in economics (rational man in the pursuit of his own self-interest and the theory of the firm) are not applicable to the Japanese economy. This idea of relational contracting and its emphasis on long-term goals takes precedence over the short-term self-interest of the individual and that of the firm. Therefore, neutrality is an inappropriate goal when attempting to understand contracting relations in Japan. Contracting must be examined as a subjective activity by individuals within the dynamics of the group.

overwhelming. The importance of national differences in accounting creates barriers to understanding foreign financial statements. Perhaps Mueller and Walker (1976, 73) understood the problem best when they stated:

The problem unique to transnational financial reporting, as opposed to financial reporting within a country, is that those interested in the financial reports "read" these reports which are apparently similar but which are in fact different in their foundations owing to different customs, different cultural heritages, different "accounting principles" and different legal requirements. It is not just that the reports crossing national lines need to be stated in different languages and different currencies to be meaningful but, rather, that they must be "translated" in such a way that the underlying events and their consequences will be communicated to audiences whose experience and education in financial reporting differ from those of the reporters. In other words, the problem is to convey to a "foreign" reader the same message as would be received by a native reader.

There are several factors that need to be considered when analyzing international financial information. In particular, there are differences in the set of accounting principles adopted in each country, differences in taxation rules and policies, differences in the financing, operating and other business arrangements, and differences in the cultural, institutional, and political environment in each country (Foster 1986).

Transferability of accounting systems and standards is a relevant issue for Polish accounting. Although there is some support for the transference of an accounting system operating in a developed country to a developing country (Lowe 1967; Seidler 1969), most contemporary researchers

TABLE 2

ANCILLARY PERSPECTIVES FOR ICFAR

Perspective	Description of Potential Benefit
Economics/organizational contexts	Avoids paradigm myopia by incorporating radical and positive paradigms to investigate accounting phenomena more intensely (Tinker, Merino, and Neimark 1982). Recommends a multi-method approach (Wallace 1987).
Critical understanding of reality	Avoids taking for granted assumptions of positive accounting research and the common-sense reasoning of everyday life (Hines 1989, 52). Recommends an approach that recognizes accounting's central role in adjudicating in exchanges between corporations and various social constituencies and explores alternatives to existing theory and practice (Neimark 1988, Preface).
Corporatist studies of accounting regulation	Examines the possibility of "private interest accounting regulation" as a fundamental form of social organization on par with community, market, and state (Puxty et al. 1987). Recommends adopting the case for corporatism as a descriptive and explanatory framework.
Sociology of accounting	Understanding accounting in its social context. Recommends studying how accounting influences and is influenced by its environment (Hopwood 1985, 372).

Source: Adapted from R. S. O. Wallace and H. Gernon, "Frameworks for International Comparative Financial Accounting," Journal of Accounting Literature (1991): 216-7).

remain skeptical. Jaggi (1975) ascertains that managers' disclosure decisions are based on a particular cultural perspective. The fewer the legal requirements, the less reliable disclosure will be in a particularistic society than in a universalistic society.⁷ Therefore, when reporting and disclosure systems from developed countries are imported by developing countries which are, in general, particularistic, the unintended consequences will produce distortion and anamorphosis of the transferred system and less reliable disclosure. Samuels and Oliga (1982) agree. They posit that the information needs and problems of developing countries are different. Attempts to adopt accounting standards, based on the needs of developed countries are futile. Standards and accounting systems should reflect the needs of the nation. If two nations are in different places along the economic development continuum and have different cultural values, then similar standards cannot serve both equally well.

Case Study Research

Since the primary objective of this study is to provide some insight into the accounting transition in Poland by

⁷A universalistic society is one in which individuals stress independence, impersonal relationships, and loyalty to the firm and to society. A particularistic orientation is one which exhibits extended family systems that emphasize personal relations and a disregard for outsiders. Typically, developed Western nations are regarded as universalistic, while developing nations as particularistic.

examining issues of valuation, financial reporting, and disclosure, an exploratory case study approach based on Kaplan's pattern model best addresses the principal and ancillary research questions. The case approach serves as a creditable research strategy "when 'how' or 'why' questions are being posed, when the investigator has little control over events, and when the focus is on a contemporary phenomenon within some real-life context." (Yin 1989, 13) Yin (1989, 14) further states that there is an emergent trend

toward appreciating the complexity of organizational phenomena, for which the case study may be the most appropriate research method . . . the distinctive need for case studies arises out of the desire to understand complex social phenomena . . . allows an investigation to retain the holistic and meaningful characteristics of real-life events.

The advantages of the case methodology to this research study are many. First, since there is no precedence for the transformation of a CPE to a market-based system, there are no explicit methods of investigation. The only certainty that exists is the past and the initial, almost cataclysmic rejection of the institutional and organizational structures of the CPE.⁸ There is wholesale rejection of the former

⁸This particularly refers to Poland's efforts in 1990 when institutional reforms were introduced to stabilize an economy plagued by hyperinflation, large-scale shortages, and an accrescent foreign debt. The stabilization program, named the "big-bang" program and/or the Balcerowicz Program, has been likened to "shock therapy" as opposed to a gradual approach to institutional reform (Rosati 1991).

system, and there are no recommended explicit methods for studying the transition.

Second, the literature review of international accounting research suggests the appropriateness of case research in the examination of financial reporting of individual nations (Meek and Saudagaran 1990; Wallace and Gernon 1991). The case methodology, in comparison to other methodologies, allows the researcher to examine the subject material within the cultural, economic, and sociopolitical context.

Third, case research is appropriate (1) when the focus is on a contemporary phenomenon and when the researcher has no control over actual events or (2) when sample size may be as small as one, which would preclude the use of laboratory and archival methods.⁹ The transition of Polish accounting is set within a rapidly evolving, volatile environment.

Neoclassical financial analysis based on "standard" assumptions is not relevant. The tenets of neoclassical economics limit the analysis to the study of allocation equilibria within a given economic system and to system statics. Dosi (1990, 339) presents an appropriate analogy for the changing dynamics of the transformation process: "It is much easier to stand up on a bicycle when you cycle,

⁹Case research is particularly relevant to Mandelbaum's (1977) concept of specialized disciplines because it provides a feasible structure for the analysis of cultural importation of accounting concepts.

rather than when you do not move." Examining the dynamics of the change rather than the statics provides increased knowledge of possible directional developments.

Neoclassical analysis cannot address the process and the interactive relationships of the legal, economic, social, and political aspects of system transformation. Wisman and Rozansky (1991) suggest that the appropriate approach depends on the subject matter. If the subject matter possesses significant transcultural and transhistorical consistencies, then an approach that incorporates a highly developed body of theoretics and a "logically" deductive axiomatic structure should be employed. Conversely, if the subject matter lacks regularities, then a body of theoretics based on preconceived assumptions is inappropriate. Kaplan (1964) similarly makes this differentiation between use of the pattern model and that of the deductive model.

Fourth, the ability to propose, explore, and critique plausible answers to "how" or "why" questions in situations in which statistical inference may lack power or be impossible is another advantage of case research. Additionally, "what" questions can also be addressed in a case strategy. Yin (1989) states that "what" questions can be either exploratory or about prevalent customs and values. Exploratory "what" questions are suitable for all research strategies, including case studies. Prevalence "what"

questions are more suitable for strategies that use surveys or an analysis of archival records.

Finally, the case method allows for multiple sources of evidence. The case study can use both qualitative as well as quantitative evidence and is most appropriate when used in situations "in which the intervention being evaluated has no clear, single set of outcomes." (Yin 1989, 25)

Research Design

This study examined the changes in Polish accounting within the context of three of the first five SOEs privatized and publicly traded on the Warsaw Stock Exchange: Krosno S.A., Prochnik S.A., and Tonsil S.A. Organization of the research adapted the use of a single-case embedded design (Yin 1989). The three industrial companies constitute the case. Each company is a logical subunit. To address the principal research question of how accounting is transforming and being transformed in Poland, periodicity is central to the analysis. This study examines two important subunits: the period of privatization and the years immediately preceding (1986-1990) and those subsequent (1991-1993) to privatization.

The research design incorporated an examination of the changing image of accounting within the transformation of the legal, economic, and sociopolitical environment. Jaruga (1993) views accounting as an "active instrument" in the new social, political, and economic environment, but she

questions the sequencing of change. Should legislation precede all accounting changes, or should accounting changes occur first? The examination of the data was conducted within the context of the legal environment and the social, political, and economic environment gleaned from the popular press and secondary sources.

Data

The Polish Securities Commission (PSC) regulates and supervises activities on the Warsaw Stock Exchange. Parliament passed on 22 March 1991 the Act on Public Trading of Securities, which established the PSC and outlined its responsibilities. On 12 April 1991, the act establishing the Warsaw Stock Exchange was signed, and on 16 April 1991 the first stock exchange trading session took place.

The PSC has responsibility for protecting investors, ensuring adherence to rules established for public trading of securities, and cooperating with other governmental bodies in promoting the development of a viable securities market. All new issues are reviewed by the commission. Application for listings must meet adequate and accurate disclosure of material facts established in the 1991 act. Each potential issuer must file an official prospectus with the PSC. If a permit is granted, the issuer is obligated to publish the prospectus in two national daily newspapers. The issuer need not have the entire prospectus published; a condensed version may be reproduced.

When the first SOEs were privatized in 1990 by the Minister of Ownership Changes, there were no securities laws. The legal basis for privatization was the July 1990 Act on Privatization. For those SOEs intended for public offerings, the Ministry of Ownership Changes set up guidelines and required a prospectus from each SOE undergoing privatization. Each SOE was required to provide information about itself and the offering with a requirement to present financial reports for the previous three years. The nonfinancial as well as financial information in the prospectuses is used in the analysis, but specific emphasis is placed on the financial reports because they represent efforts at valuation and present accounting information retrospectively.

During the communist period, the Central Statistical Office (GUS) served a quasi-accounting function, requiring statistical reports for central planning purposes. The yearly reports provided accounting information regarding assets, liabilities, and special funds. GUS reports from the 1986-1989 period are analyzed to determine valuation issues.

Finally, after each company became publicly traded, legal requirements dictated the issuance of yearly financial reports with disclosures. The financial statements in addition to various filings with the PSC are used in the analysis of the 1991-1993 period of accounting information.

Overview of the Study

Chapter 2 provides a broad overview of the political/economic and social changes occurring during the transition and focuses on the structural modifications required to move from a communal to a public society during the period 1989-1991. This period is significant because it represents the time frame in which Krosno, Prochnik, and Tonsil decided to apply for privatization, were privatized, and then began life as publicly traded companies. Knowledge of the macro-changes affecting society assists in understanding the scope and the limitations of accounting. Although chapter 2 deals with broad transitional issues whose direct impact on an individual SOE cannot be measured, those factors have been found relevant to understanding the development of accounting by prior researchers (Choi and Mueller 1978; Gray 1989).

Privatization and the changes in the business environment are addressed in chapter 3. These changes cannot be measured statistically, but directly affect the demands and requirements on accounting. Many of the new business relationships and institutions were imposed by Western sources and reflect cultural importation. Examining these new interdependencies assists in understanding accounting within its operating context (Gray and Roberts 1991).

Chapter 4 examines the actual valuation of assets of the three SOEs, how accounting was used in the privatization process, and how accounting continued to be used as an instrument for change. An analysis of the GUS statements versus the financial statements in the prospectuses of the same period provides empirical evidence regarding the valuation process. Subsequent financial reports provide evidence on the assimilation process of Western accounting as well as the dysfunctionality created by cultural importation. Chapter 5 presents the conclusions and suggestions for future research.

Contributions

The contribution of this research to the accounting literature is manifold. First, this study provides unique knowledge about the valuation process incorporated in a privatization environment. Second, information regarding the development of new accounting principles and practice in a rapidly changing environment are presented. Third, the subsequent analysis facilitates an understanding of the organizational, social, and political aspects of accounting in a specific transitional economy. Fourth, the research brings expertise to an area where there is little indication that the past will reflect the future. Fifth, the analysis provides descriptive accounting information about a specific segment of privatized firms. Sixth, the research promotes interest in the development of possible databases for future

investigation and analysis. Seventh, this study responds to Meek and Saudagaran's (1990) call for more research efforts devoted to the dramatic changes in Eastern Europe and the former Soviet Union. The findings in this study are of interest to those researchers and accountants concerned with the harmonization of accounting and reporting internationally as well as within the EC by a country in the developmental stages economically.

CHAPTER 2

THE POLITICAL AND ECONOMIC TRANSFORMATION

Introduction

In order to answer the research question, "How is accounting transforming and being transformed in Poland?" it is necessary to understand how accounting changes were made, the impact of those changes, and the intended and unintended consequences of change. Accounting changes were not made in isolation. They were made in the context of the political and economic transformation. At the outset of Polish democratization, Cyrus Vance, as head of a special task force to Poland, advised the newly elected premier, Tadeusz Mazowiecki, to establish as quickly as possible a comprehensive accounting system for an open market economy (Cheney 1990).

The demands placed on accounting were formidable. Accounting numbers were used to make decisions about the direction of reforms. Accounting was used, willingly or not, as a broker in the transition from socialism to capitalism. Traditional Western accounting, with its focus on calculation of profit and ownership, played an important role in creating a new economic reality.

An examination of the political and economic developments in the transition provides a better understanding of accounting's potential as a facilitator for long-term economic welfare. Koslowski (1992) posits that the economic transformation based on a neoclassical view of economics could not succeed because it presumed the existence of a functioning political sector. But the objective of communism had been the abrogation of the state and the supremacy of the Communist party. When the political opponents of the Communist party triumphed, their reward was not the return of the state to the democratically elected but simply the right to rebuild a state that had collapsed years ago.

The transition began on 12 September 1989 with members of Solidarity playing a leading role in the formation of a coalition government. The Solidarity-led government inherited an economy in deep crisis and depicted the restoration of a market economy as the solution to this emergency. The new government introduced a stabilization¹⁰ package that was directed and supported by the World Bank and the International Monetary Fund (Wellisz 1991a, 1991b).

At the onset of the democratization process in Poland, a number of immediate changes were viewed as crucial to

¹⁰In this context stabilization refers to macro-economic steps undertaken to prepare the economy for various democratization measures. When stabilization efforts began in 1990, goals included the reduction of the budgetary deficit and inflation control.

"jump-starting" the move to a market economy.¹¹ Privatization, labor market reform, the development of capital markets, currency convertibility, price liberalization, macroeconomic stabilization, and welfare reform all become part of the "big bang" approach to Polish democratization.¹² The objectives of this approach were to place the means of production under private ownership and to create broad multidimensional societal changes that included major shifts in the legal, social, and economic institutions in Polish society.

In a sense this approach advocates bypassing existing sociopolitical institutions to create a new economic reality. The passage of hundreds of new laws based on compliance with European Community (EC) standards and the

¹¹The architects of this macro-approach, also known as shock therapy, are Harvard economists Lipton and Sachs (1990). Their view on privatization is important to the property rights issues. Lipton and Sachs believe that privatization must begin by rejecting all existing ownership claims. They state: "Shifting to a Western European ownership structure will of course require that enterprise governance be removed from the workers' councils and managers and placed squarely in a supervisory board (or board of directors) controlled by the owners of the enterprise. In essence, privatization of the enterprises requires first that ownership rights, now vested in the enterprises, and particularly in the workers' councils, must be eliminated." (Lipton and Sachs 1990, 308). Lipton and Sachs (1990) advocate a top-down approach that would instantaneously redefine property rights and immediately disenfranchise labor from their productive efforts.

¹²Advocates of the "big bang" or top-down approach are orthodox economists as opposed to institutionalists who believe that a bottom-up approach is necessary. In order for changes to be effective, they first must be internalized by society.

establishment of institutions designed to emulate a market economy could not succeed until major social and institutional changes occurred.

Debate over the ability of the "big bang" approach to produce the desired changes continues to rage. Programs of rapid and all-encompassing liberalization have had limited success. Third World attempts at economic liberalization have demonstrated the limited success of this approach. While the initial public reaction to reform has been favorable, disillusion often sets in during the long and painful transition process. Certain interest groups become disenfranchised from previous rights and privileges, discontent and acrimony set in, and mobilization of the disenfranchised creates political pressure to reverse or stop reformist policies.

Almost all programs of vigorous liberalization proceed initially by ignoring or repressing organized labor. Failure to reincorporate labor is likely to set the stage for future conflict . . . In the changed international climate of the 1990s, labor and other popular-sector groups are likely to press for access to decision makers sooner than they did in the less prodemocratic decades of the 1970s and 1980s. (Nelson 1993, 439)

The remaining chapter examines the political and economic developments that created the framework for the business environment and privatization of state-owned enterprises (SOEs) in chapter 3. The discussion is limited basically to 1989-1991, the time frame in which the first SOEs were privatized and first publicly traded.

1989, the Precursor for Change

The year 1989 was a milestone in the history of economic and political systems. The political changes that occurred in Poland heralded a new political and economic order of nations. Ironically, the term "domino theory" that was coined by the United States government to justify its presence in Southeast Asia in the 1960s and 1970s became operational as the Soviet Bloc disintegrated. Each country, rejecting in its own fashion the ruling Communist party, began forging its own road of political and economic democratization.

Poland's rejection of its former system was neither abrupt nor unexpected. The events that led up to the unprecedented June 1989 elections that brought Solidarity forces into power began with the imprisonment of those same Solidarity members during the state of emergency in 1981 and the subsequent communist government's unsatisfactory attempts at economic liberalization in the 1980s. The Communist leadership promoted economic liberalization to maintain political power, but these liberalization efforts proved ineffective to reduce the ever-increasing shortages and inefficiencies of the system due to the constraints inherent in a centrally planned economy (CPE). The major objective of the CPE was to maintain full employment. To do this, the CPE maintained artificially low prices and low wages. The low wages mandated artificially low prices for

basic consumer commodities. Thus, the price of a loaf of bread did not cover the fixed cost of its ingredients.¹³ The combination of low prices and low wages led to a vicious cycle. The government directed more and more resources to value-decreasing enterprises to provide basic commodities and to ensure full employment. Workers, assured of jobs, had no reason to increase productivity since their wages were fixed.

Three important events created the impetus for change: a joint venture law, the Round Table Meeting, and the June 1989 elections. The unintended consequences of these events were the dissolution of the Communist party, the Polish United Workers' Party (PUWP), and the CPE.

The Joint Venture Law

The joint venture law passed in 1988, Polish Law No. 325 Governing Economic Activities with the Participation of Foreign Entities, provided the impetus for a small-scale market economy. This law, effective on 1 January 1989, permitted small privately held companies to engage in joint ventures with foreigners as well as the establishment of companies with 100% foreign ownership. It was an immediate success.¹⁴

¹³See Rzeczpospolita (14 February 1989, 1) for a discussion of the dysfunctional pricing system.

¹⁴Although Rzeczpospolita was censored until 1990, the joint venture law evoked a discussion in the press in early 1989 about the benefits of economic liberalization and the

Round Table Discussions

Political liberalization accompanied the liberalization of economic activity. On 27 January Czeslaw Kiszczak, representing the Jaruzelski government, met with Lech Walesa and began a political process that ultimately led to the dissolution of the PUWP. Fifty-seven individuals began a series of discussions on 6 February to offer solutions to Poland's economic problems.¹⁵ The discussions continued until 5 April when a final agreement that pledged both political and economic reforms was signed. The participants agreed to support free speech, pluralism, and semi-free elections. The Round Table agreement allocated 65% of the seats in the Sejm to the PUWP.¹⁶ The agreement allowed the opposition to contest only 35% of the Sejm seats. The Senate, which was created as a result of the Round Table agreement, did not have any imposed quotas. The 100 seats could be contested by all parties.

impact that foreign ownership would bring to the Polish economy (27 January 1989, 1; 30 January 1989, 6; 2 February 1989, 1; and 31 December 1989, I).

¹⁵The Jaruzelski government extended an invitation to the Round Table meetings to all groups in political opposition to the PUWP. Members representing Solidarity, the church, other sanctioned and unsanctioned political groups, and legal trade unions were brought together to find a solution to the economic crisis.

¹⁶The Sejm is the name given to Poland's legislative body. During the Communist period, it was controlled by the PUWP. At the Round Table discussions, the legislative/parliamentary body was expanded to include a newly established senate.

The Round Table participants agreed to (1) development of autonomy and worker participation, (2) formation of a private property structure, (3) development of a free market and competition, and (4) significant limitations on the Central Planning Committee to foster economic development.¹⁷ The recommended changes occurred rapidly, facilitating both economic freedom and freedom to dissent. Changes in political programming of radio and television and the legalization of opposition political parties signalled the end of Communist rule.¹⁸

The June 1989 Elections

After the historic Round Table meeting of the PUWP with the oppositional faction, change accelerated. On 13 April the Council of Ministers approved national elections for 4 June. These elections were a milestone, as those opposed to the PUWP were allowed to openly participate. Jaruzelski made a trip to Moscow at the end of April to meet with

¹⁷For a discussion of the details of the agreement see Rzeczpospolita (5 April 1989, 1 and 8-9 April 1989, 4-6).

¹⁸On 19 April 1989 Rzeczpospolita reported that Solidarity officially registered in Warsaw as a national organization headquartered in Gdansk. On 2 May 1989 Rzeczpospolita announced that Solidarity was allowed its first legal radio broadcast. By 12 May Solidarity's press agent, Janusz Onyszkiewicz, announced that regional Solidarity committees had been established and local authorities were cooperating, providing these regional enclaves with locales.

Gorbachev. The rhetoric indicated that there would be no interference from Moscow when Gorbachev stated:

I would like to convey to our Polish friends and brothers in the name of our leaders and society . . . warmest congratulations and success in matters of great concern pertaining to the renewal of Poland.¹⁹

It is not clear why Gorbachev allowed the Polish liberalization to continue, but all indications confirm that the deteriorating economic condition in the Soviet Union, exacerbated by the Afghanistan war, may have contributed to the Soviets' reluctance to interfere.

Preparation for the 4 June primary election and the 18 June runoffs began after Jaruzelski returned from Moscow. The election itself required special preparation because it differed from all other post-World War II elections in Poland. Multiple party ballots required a different kind of voting system.

No one was prepared for the election results. Solidarity's candidates won over 60% of the positions. In the Senate Solidarity candidates received all but three of the 100 seats. Consequently, when the Polish Sejm and Senate met on 4 July 1989, a new parliamentary political

¹⁹The context of Gorbachev's speech was reprinted in Rzeczpospolita (2 May 1989, 7). Jaruzelski had met with Gorbachev on 27-28 April 1989.

order existed which necessitated the formation of a new coalition government.²⁰

The first order of business was the election of a president. The newly-elected National Assembly selected Jaruzelski on 19 July 1989. The opposition, still shocked by its success, acquiesced to Jaruzelski's selection, but was not as accommodating when Jaruzelski began the task of selecting a new government. The first step was the appointment of a premier. Jaruzelski's first and second choices (Wladyslaw Baka and Roman Malinowski) both declined, and his third choice (General Czeslaw Kiszczak, a member of the PUWP central committee) was not acceptable to the newly elected National Assembly. On 21 August Jaruzelski proposed Solidarity activist Tadeusz Mazowiecki for premier and president of a new coalition government cabinet. On 24 August the Sejm unanimously approved Mazowiecki's appointment. Three weeks later, on 14 September 1989, the Sejm also approved Mazowiecki's political and economic program and government appointees, including Leszek Balcerowicz as Minister of Finance. Mazowiecki's government represented a coalition of four parties: Solidarity, PUWP, Social Democrats (SD), and the Peasant Party (ZSL).

Mazowiecki set out to establish a legitimate, independent Polish government. Equally important was

²⁰See Rzeczpospolita (31 December 1989, III) for a discussion of the events preceding Mazowiecki's coalition government.

control over inflation and economic normalization. Mazowiecki viewed the establishment of private property rights and a stock market as essential elements of his reforms. He also emphasized that the transformation would be painful, stating that:

it is necessary to emphasize that there is no example in world economic history where high inflation has been brought under control without serious pain in society such as the bankruptcy of firms and the unemployment of workers.²¹

His warning proved prophetic as economic reforms proceeded slowly due to resistance to hardship caused by radical economic changes.

Economic Liberalization and Change

The Sejm passed measures to remove certain administrative limitations on producers and retailers of foodstuffs and eliminated many fixed prices. The liberalization of prices took effect on 1 August and created confusion in the marketplace. Although the intent had been to fill the stores with goods, the initial effect was chaotic pricing and inconsistent supply.²²

The chaos created by the new pricing system of foodstuffs in the marketplace resulted in runaway inflation

²¹See Mazowiecki's discussion of the anticipated difficulties in Rzeczpospolita (14 September 1989, 1).

²²For a discussion of the Sejm resolutions and the effect of price liberalization see Rzeczpospolita (1 August 1989, 1-2; 5-6 August 1989, 1; 8 August 1989, 2; 9 August 1989, 1; and 12-15 August 1989, 1).

for most goods and services. In September prices rose 52% and in October retail prices escalated another 54.8%.²³ Workers, caught between low wages and increased prices, demanded immediate government action. The government responded with a new economic program, the Balcerowicz Program.

Balcerowicz Program

On 6 October 1989 the new Minister of Finance, Leszek Balcerowicz, presented to parliament an austerity program for 1990 designed to combat inflation. The program sought to reduce hyperinflation by introducing the following reforms: (1) a balanced budget that severely cut government spending, (2) an increase in energy and coal prices, (3) a devaluation of the zloty, (4) a freeze on wages, and (5) a complete restructuring of the factors of production. The program also called for privatization of SOEs and other market reforms. The Sejm approved the plan with little opposition.

Balcerowicz (1989) predicted that the next few months would be difficult, but he argued that adoption of an austere economic program would facilitate support from the international community. Since the program was constructed under the guidance of the International Monetary Fund (IMF),

²³See Rzeczpospolita (31 December 1989, IV) on escalating prices.

Balcerowicz counted on financial support from the West. He understood some of the immediate ramifications of the program and assured Poles that the Ministry of Finance had begun to develop a safety net for those individuals and enterprises put at risk because of the change from a CPE to a market-driven system.

The Balcerowicz Program required the restructuring of industry by privatization of all SOEs. But legal changes had weakened the PUWP's control over business activities, while the issue of private property rights had yet to be addressed. This enabled PUWP members who controlled the SOEs to appropriate and seize enterprise assets, in part or in total, and to sell shares in the newly formed companies.²⁴

The initial results of the economic program were not reassuring. The government badly miscalculated the effect of price increases. Inflation reached 80%, not the 50% predicted, and the predicted "slight decline" in productivity turned out to be an actual decline of 20%. An unexpected demand barrier also surfaced. The new, higher prices of Polish goods stimulated a market for imported foreign goods, which in many cases were cheaper and better quality than domestic goods. For example, Rzeczpospolita's

²⁴Some insight regarding the structure of these companies can be found in Rzeczpospolita (30 August 1989, 1; 29 November 1989, 1 & 2).

management examined four foreign proposals to buy paper, all at lower prices than domestically produced paper.²⁵ In the end the Balcerowicz Program managed to ensure an adequate supply of goods in the shops, reduce hyperinflation, and maintain the convertibility of the zloty. However, it failed to produce any major policy changes in state industries and left one-third of the nation in poverty.

Aware that the economic program created hardships among the populace, the Mazowiecki government decided to modify the program to cushion its impact. Foremost on the agenda was the development of an environment that would encourage enterprises to change their behavior patterns. Balcerowicz believed that encouraging greater competition, liquidating monopolies, reducing tariffs, developing financing sources for new businesses, and providing the legal framework for privatization would stimulate the economy and reduce the negative consequences of the economic transition (Gasiorowska 1990).

Economic reform proved intractable and contentious. In May 1991, after more than 16 months of reform, members of the Sejm responded negatively to a government report that called for more stringent measures to ensure compliance with

²⁵See Osiatynski (1990), Gajewska (1990), and Maj (1990) for a discussion on the emerging demand barrier and the recession following economic liberalization.

the IMF agreement on the budget. The restructuring plan required approval from the Sejm for any changes.²⁶

Balcerowicz and Bielecki blamed the Sejm for blocking economic reform.²⁷ A heated debate ensued, but the government could muster little support in the Sejm for more stringent economic measures. Shock therapy had failed. Włodzimierz Cimoszewicz, former leader of the PUWP, cited the increase in strikes as a testament to the economic hardships placed on the nation by economic reform. Solidarity union members sided with the Sejm, staging its first official protest against the Solidarity led government's economic and social policy on 22 May 1991 (Cydejko 1991b).

By 1991, most Poles believed that shock therapy had failed because economic performance continued to deteriorate. The budgetary goals established by the IMF had not been met, imports threatened the viability of many domestic industries, and no satisfactory resolution had been

²⁶Goszczyński (1991, 3) provides a discussion on the economic program and Balcerowicz's address to the Sejm. Balcerowicz began the session, stating that "the systemic changes affecting the Polish economy are again at a very difficult stage. Perhaps we have reached a watershed. On the one hand, we have an accumulation of economic problems, and, the most fundamental of these are linked to the breakdown of the economic system in Eastern Europe, especially the dramatic collapse of our export to the Soviet market. On the other hand, we are already witnessing the first symptoms of pre-election fever."

²⁷Jan Bielecki followed Mazowiecki as premier of Poland in January 1991. Bielecki led the second Solidarity-based government in post-communist Poland.

found for settlement of Soviet accounts. Rampant inflation continued, and unemployment created unrest. Although the Bielecki government continued to govern, it had lost popular support.²⁸

Devaluation of the zloty reinforced the perception of economic malaise. In May 1991, the government realized that it could no longer maintain the official exchange rate established in January 1990 and devalued the zloty. The Polish National Bank changed from pegging the zloty to the United States dollar to use of a weighted basket of currencies to increase the competitiveness of Polish products.

A basic conflict in economic policy emerged. An increase in competitiveness meant an increase in the budget deficit. To increase the competitiveness of Polish products both on the export and the domestic market, the Polish National Bank introduced a crawling peg of 1.8% in October 1991. The zloty continued to fall throughout 1991, enhancing competitiveness but exacerbating the budget deficit (Gwiazda 1990b; Sowinska and Bartyzel 1991; Zygulski 1991c).

At the end of 1991 Jan Olszewski became the third premier since liberalization. Olszewski removed Balcerowicz from the post as Minister of Finance, but a change in

²⁸For a discussion of economic difficulties, see Glogowski (1991).

government did little to improve the economic situation. Comisso (1991) suggests that existing internal factors made the transformation difficult. A change in economic policy was necessary but not a sufficient condition for the establishment of a market economy. The establishment of a well-defined property rights regime constituted another necessary condition that had not been met. Although a new economic policy had been defined, the relationship between the state and the economy remained indeterminate with an ineffective rule of law.

Major External Impediments

Four external factors--the dissolution of the Council for Mutual Economic Assistance (COMECON), tariff barriers, the Middle East oil crisis, and the disintegration of the Soviet Union--further complicated transformation. Many energy-dependent industries faced insolvency when oil subsidies were eliminated, as did those Polish companies that produced goods primarily for the Soviet market that had been subsidized by COMECON.

COMECON

COMECON was established in January 1949, at the beginning of the cold war. COMECON became a political tool that allowed the Soviets to control the economic fortunes of each of its members. Entire industries were created to service the Soviet economy. The Soviets mandated production

choices, volume of output, the terms of all transactions, and type of payment as well (Gwiazda 1990a).

By 1990 COMECON began the difficult transition to market prices. At COMECON's 45th session in Sofia in January 1990, discussion centered on a complete reconstruction of the trading system. Settlement of accounts between COMECON countries would no longer be in transfer rubles but rather in a convertible currency.²⁹

In January 1991, an agreement was reached to settle all accounts in a convertible currency. With the move to a convertible currency, COMECON became defunct. Top secret documents made public in 1991 revealed the magnitude of COMECONs influence over the economic affairs of the former Soviet Bloc. The Soviet-controlled economy fostered obsolete production and hampered initiatives to improve performance in Soviet satellite countries like Poland. The official disbanding of COMECON occurred in Budapest on 28 June 1991 during its 46th session (Sowinska 1990a).

The year 1991 ushered in a new phase of trade as the settlement of accounts no longer relied on the transfer ruble but on a convertible currency at world prices. The elimination of forced trade effected major changes in the

²⁹See Swiecicki (1990) for a discussion of the COMECON changes. Some changes had been anticipated since 1989 when Poland had signed an agreement with the Soviet Union to value 10-15% of overall trade at world prices, but the magnitude of the changes on economic stability were not foreseen.

pattern of trade for Poland as well as the other countries of the former COMECON. A collapse of mutual trade transpired that directly affected the level of financial distress of SOEs. Those SOEs that had been created specifically to service the COMECON market faced bankruptcy. Their technologically outdated and inferior quality products were unsuitable for other markets (Stefaniak 1991a, 1991b; Zygulski 1991).

Tariff Barriers

Those SOEs that could produce high-quality exportable goods also faced significant tariff barriers. The EC and the United States, while lending Poland moral support and dollars, refused to lift tariffs and quotas on Polish products. Thus, the Polish market was flooded with subsidized EC goods, especially food products, while Polish producers were shut out of those same markets by protective tariffs.

Middle East Crisis

The Middle East Gulf War and subsequent oil crisis also impacted adversely Poland's efforts at privatization. Iraq had been Poland's most important purchaser of arms. Arms were traded for Iraqi oil. With the Middle East conflict and later the embargo on Iraqi oil, Poland suspended its delivery of arms to Iraq and lost a major source of oil. The embargo also precluded Iraq from paying for past

shipments with oil. In 1990 Iraq had contracted with Poland to deliver one million tons of oil in payment for past debts; the United Nations embargo prevented the fulfillment of the contract. Poland's economic situation deteriorated because Poland was obliged to buy oil from other sources in hard currency (Gajewska and Pawluk 1990).

Disintegration of the Soviet Union

Although the United Nations embargo of Iraq placed Poland in an untenable situation regarding Iraq's debts to Poland, the situation in the former Soviet Union created economic chaos. In 1990 Poland relied heavily on the delivery of oil and gas from the former Soviet Union. The exacerbation of the internal crisis in the former Soviet Union delayed and even halted shipments of oil and gas. As the disintegration of the Soviet internal structure proceeded, enterprises created specifically to service the Soviet market had nowhere to sell their products. Former customers in the Soviet Union were either unable or unwilling to pay for Polish products in a convertible currency (Bien 1990).

Both internal and external factors impeded the transition. The lack of a clearly established state encumbered economic transformation. Because a large state framework is necessary to regulate a capitalistic society, Poland was unable to institutionalize the private property rights necessary for a market system. The mechanisms

necessary for a private property system did not exist. Comisso (1991) posits that the relationship between a state and an economy is defined by three factors: (1) the exercise of property rights by economically driven agents, (2) the impartial adjudication of disputes as to those property rights, and (3) the jurisdictional specification of property rights that is removed from both those exercising their rights and those enforcing compliance. None of these relationships had been established in Poland at the onset of the privatization process because the necessary legal reforms have yet to be enacted and institutionalized.

New Economic Formations

The dissolution of the Soviet Union and the collapse of COMECON required drastic changes in trading patterns. From a predominantly Eastern orientation, Poland turned Westward for both economic and political support.

The former Soviet satellite countries, faced with protective tariffs in Western Europe and the dissolution of their Eastern markets in the Soviet Union, banded together to form Visegrad to promote economic cooperation in 1990.³⁰ While Poland, Hungary, and Czechoslovakia signed a

³⁰Czechoslovakia, Poland, and Hungary turned to regional cooperation in 1990 at the prompting of the EC. This cooperative overture was named Visegrad, after the Hungarian city where the first meeting was held on 14-15 February 1991.

cooperative agreement at the urging of the (EC), Visegrad has not yet become an effective organization.

The lack of success may be partially attributed to the conflicting goals of the former Soviet satellite countries and the EC. Poland, Hungary, and Czechoslovakia agreed to cooperate because they viewed Visegrad as a first step in the integration process for membership in the EC.³¹ The EC may have shared this view, but time horizons differed significantly with respect to when EC membership might supersede Visegrad.

On 5-6 October 1991 the members of the three governments met in Cracow in an attempt at further cooperation. Urbanowicz (1991, 3) reported:

The triangle is a marriage entered into at the West's bidding, a marriage of convenience rather than love. In return for it, the three states received a joint mandate to negotiate with the European Communities and attained the position of favorites among the post-communist states.

While discussions were held on establishing a joint economic policy toward the Soviet Union, the formation of a free-trade zone among the Visegrad members, and the creation of a Central European Bank, no concrete steps were taken to implement any of the economic solutions.

The leaders of the triad became increasingly critical of the West's attitude toward the emerging democracies in

³¹For a discussion of the different views on Visegrad see "Labor Ministers Meet, Toward a Common Policy," Warsaw Voice (6 October 1991, 3).

Eastern Europe. Initial overtures at regional cooperation failed because its members viewed it as a stopgap measure to gain EC membership. The main objective was integration with Western Europe.

World Support for Privatization

The major industrial nations of the world wanted the Eastern European privatization effort to succeed. EC countries and the United States, along with the IMF and the World Bank, provided substantial funding to Poland. But the funding often came with restrictions that limited its use. The low utilization factor was due to a variety of reasons, such as unresolved private property ownership issues, lack of technical knowledge, and the inability of Polish managers to understand the requirements of Western accounting principles (Zygulski 1991a).

The Polish government's initial overtures for EC membership came in 1989. The government, guided by EC standards, began its efforts to change its economic and legal foundations (Zygulski 1991b). Development of an effective communications and transportation infrastructure became the first priority. The Polish Post Telephone and Telegraph received a five million ECU grant for postal development. Additional monies were set aside for the

development of transportation and scientific cooperation between the EC and the countries of Eastern Europe.³²

Although the EC was anxious to assist in the transition with specifically created programs, objections to membership centered on trade issues.³³ Work on the association agreement for Poland, Czechoslovakia, and Hungary continued amidst a French veto on the importation of meat and Portuguese objections on access of textiles from the triad. By the end of September 1991 France withdrew its veto and work continued on the elimination of textile quotas within a five-year window (Zygulski 1991d). On 16 December 1991 Poland, Hungary, and Czechoslovakia signed an association agreement with the EC.

Renewed United States/Polish Relations

The government awarded Poland \$715 million in aid in November 1989 as part of the Support for East European Democracy Act Program. Additional support included food aid, the establishment of the Polish-American Enterprise Fund, environmental protection assistance, English-language training through the United States Peace Corps, computer

³²See "In Brief," Warsaw Voice (16 June 1991, 12) for a discussion of difficulties with foreign credits.

³³The ECs initial program, PHARE, commenced in 1989 to assist Poland and Hungary in the transformation. By 1993 PHARE had provided Poland with 805 million ECUs designated for support of various sectors of the economy including agriculture, education, financial, industrial restructuring and investment. See "PHARE funds, see "PHARE Money Dished Out," Warsaw Voice (8 August 1993, F1).

equipment for the Polish parliament, farmer-to-farmer exchanges, technical assistance in the restructuring of industry through the International Executive Service Corps and the Citizens Democracy Corps, and technical assistance in banking and financial services (Wackerbarth 1990). While these programs provided much needed relief, they addressed problems only peripherally and failed to address the immediate problems of rapidly declining productivity and purchasing power and the incongruities between the newly developing state and economic policy.

Western consultants arrived, ready to assist in the transition, applying market solutions to a CPE in transition. Because private property rights issues remained unresolved, application of market solutions rarely produced the intended results. A large amount of capital investment was needed to (1) restructure the economy, (2) develop a market infrastructure, and (3) address the needs of the human capital. Western governments, the IMF, and the World Bank prioritized the needs and provided the capital to address "1" and "2" at the expense of the human capital. Although much rhetoric existed about satisfying the needs of labor, privatization and other priority restructuring efforts extracted labor's rights to property where property rights were ill-defined because of unclear distinctions between communal and public property.

International Monetary Fund

Poland's 1989 economic reforms were based on IMF recommendations (Styczek 1993b). The IMF provided Poland with over \$720 million in standby credits to support the economic transformation based on the tenets of the Balcerowicz Program. The IMF focused on the privatization process and required Poland to follow a rigid schedule for economic restructuring.³⁴

The IMF required rapid restructuring, and the Polish government complied, submitting detailed plans for restructuring during the 1991-1993 period. Poland had little choice because submission of a plan approved by the IMF was a precondition for the Paris Club debt-reduction plan.³⁵ The IMF was to monitor the progress of the restructuring process on an ongoing basis, with the first official review to be scheduled before 15 August 1991 and the second before 15 February 1992 (Sowinska 1991b).

In a letter addressed to the IMF, Minister of Finance Balcerowicz and National Bank of Poland President Wojtowicz outlined the major goals of the 1991 restructuring program.

³⁴See "IMF-Poland, Big Bucks," Warsaw Voice (18 February 1990, 13) for a discussion on IMF requirements.

³⁵One of the most important factors that precipitated the Communists' loss of political control was the \$40 billion foreign debt that Poland could no longer service. The debt was owed to foreign governments (Paris Club) and foreign banks (London Club). IMF and World Bank assistance was predicated on Poland's (1) ability to negotiate a reduction of the debt with individual Paris Club and London Club members, and (2) maintaining a strict fiscal policy.

The program proved to be too far-reaching and inimical with reality. The plan called for the commercialization of an unrealistic number of enterprises, the implementation of a mass privatization program that had neither been defined nor approved by parliament, the liquidation of ineffective enterprises based solely on short-term economic considerations, liberalization of laws related to foreign investment, demonopolization of specific economic sectors, reformation of the financial sector to facilitate privatization and the allocation of capital, and the implementation of a new fiscal system inclusive of new taxes and tariffs.³⁶ The plan attempted to effect the development of a market system in one year, a process requiring many years in other countries. It is no surprise that the implementation fell short of its goals.

Poland's failure to meet IMF criteria slowed the restructuring process since much of the pledged funding was withheld due to the failure to meet established goals (Sowinska 1991a). Imposed criteria based on a fully functioning market system were impossible to implement in an ossified post-communist system. A balanced budget, the IMF's and World Bank's measurement of compliance, was unreasonable without the disenfranchisement of labor.

³⁶See "Letter to the IMF," Warsaw Voice (12 May 1991, 12) for a discussion of the changes required for compliance with the IMF's stringent guidelines.

World Bank

Koslowski (1992) concludes that a market economy did not materialize in Poland when prices were liberalized and currency convertibility was established. He attributes this to an inadequate physical infrastructure, communications, transportation, and energy sources that prevented a quick transition from occurring. The World Bank recognized the difficulties of the antiquated Polish infrastructure and provided loans to develop the infrastructure.³⁷

Recognizing the need for labor mobility, loans for housing were also available. The inability of the Sejm to settle property rights claims made it difficult for Poles to obtain these loans and the construction industry to expand domestically since land ownership remained unresolved.

At the end of February 1990, World Bank president Barber Conable arrived in Poland for a three-day visit. He

³⁷Poland joined the World Bank in 1986 and became a member of the International Finance Corporation (IFC) in 1987. By the time that the Mazowiecki government arrived, negotiations for assistance with the World Bank and the IFC were underway. In 1988 Poland received a \$17 million loan from the IFC for investment in the agro-food sector that would increase Hortex's export capacity of frozen vegetables and fruits. Early in 1990 the IFC granted Poland a \$30 million loan for the Polish Export Development Bank as investment financing for small private industrial and agro firms exporting to the West. In a separate effort the World Bank agreed to a \$15 million loan that would assist in the (1) purchase of environmental monitoring devices for Cracow, Katowice, and Legnica and (2) development of a water management system for the upper Vistula water basin. For further discussion on Poland's membership in the World Bank see "In Brief," Warsaw Voice (28 January 1990, 13; 18 February 1990, 12).

came to finalize two loan agreements (\$260 million for industrial export development and \$100 million for the development of agricultural exports). The World Bank made future funding contingent upon Poland's ability to restructure its old debt with both the Paris and London Clubs (Sowinska 1990b). However, the export restrictions attached to the agricultural loan led to underutilization. By the end of 1990, Polish companies borrowed only \$1 million because of the prohibition against use of the money to expand sales in domestic markets. Although Poland had received close to \$2 billion in commitments from the World Bank since the onset of reforms, reports in June 1991 indicated that only 15% of 1990s loan amount had been utilized.³⁸

After the Sejm passed the first privatization law in July 1990, Poland was awarded a \$300 million loan for economic restructuring. Other international organizations and foreign governments provided financial support for the transformation, but like most IMF and World Bank assistance the key to accessing much of the money was contingent on privatization of the economy which was dependent on an established state structure for implementation.

³⁸For a discussion regarding specific World Bank loans see the following Warsaw Voice articles: "In Brief," 5 August 1990, 13; "World Bank Grants Loans," 29 July 1990, 12; and Malgorzata Szyszlo-Duszczuk, "Housing, And Now For Mortgage," 26 May 1991, 12.

The Development of a New Polish State

From the very beginning of the liberalization process, difficulties arose in the government's attempts to establish a new Polish state. While all agreed that the communist constitution was unacceptable, the numerous political factions that arose could not agree on a new constitution. The failure to gain consensus on a basic document that delineated political duties and responsibilities precluded effective reform. Concomitantly, the inability of Solidarity to exact punishment on the Communist party for past wrongs foreshadowed the difficulty the nation would have in establishing an effective governmental structure.

The Dissolution of the Communist Party

The demise of the Communist party in Poland occurred in January 1990 at the party's 11th Congress, when its members unanimously decided to dissolve the party.³⁹ The decision had two very important implications. First, it raised questions about the legitimacy of the communist government elected in 1989. The people supported Solidarity and not the now-defunct Communist party.

Second, the party had vast holdings, including those related to the Workers' Publishing Cooperative (RSW), a

³⁹Two social democratic parties assembled from the vestiges of the PUWP, the Social Democratic Union, under the leadership of Tadeusz Fiszbach, deputy speaker of the Sejm; and the Social Democratic Party of the Republic of Poland (SDRP), under the leadership of Aleksander Kwasniewski, respectively (Goszczyński 1990d; Majman 1990c).

press monopoly that financed the party. The question of who owned RSWs assets became a major issue. Party leaders controlled the assets and proceeded to appropriate RSWs real estate, party archives, and the PUWP Central Committee's building for their own use.⁴⁰ The Solidarity membership was outraged and introduced legislation that allocated the assets to the state treasury as a temporary measure to safeguard the remaining assets. A liquidation commission was set up to terminate the monopoly of the press and to privatize the individual titles (Kulicka 1990). The confrontation over the RSW foreshadowed the difficulty in determining ownership of state assets and preventing former communist leaders from benefitting unduly from privatization. The inability to prevent the nomenklatura from appropriating communist-controlled assets created some popular opposition to market reform.

The Collapse of the Solidarity Movement

Solidarity's success in the June 1989 elections precipitated the downfall of the communist system in Poland.⁴¹ When Mazowiecki became premier in September

⁴⁰The RSW was founded in 1947 and controlled all print material, publishing houses, print shops, distribution networks, and press titles in Poland.

⁴¹The Round Table talks compelled Solidarity to become a political party, contrary to its roots. Solidarity emerged in 1980 as a heterogeneous mass-protest, civic movement. What cemented it was a will to bring down the then-existing political and economic system. In 1990 Solidarity was faced with essentially multidimensional

1989, Solidarity activists and advisers dominated the coalition government, almost overnight overseeing powerful government posts. The united movement had triumphed over communism, but by doing so had lost its cohesive thread, the fight against communism. Initially the Mazowiecki government had the unequivocal support of the people, but, as the transition demanded more and more concessions and sacrifices from the working class, support waned. Real wages decreased, and workers lost job security as inefficient firms had to be closed. The unified workers' movement began to unravel, and 1990 signaled a new era, the fragmentation of Solidarity.

When the PUWP dissolved, fragmentation occurred rapidly. Walesa moved to the right, others to the left, while Mazowiecki maintained a centrist position. Six months after the dissolution of the PUWP, Solidarity lost its focus and had no coherent program to offer.

Walesa and the Move to the Right

The development of the Polish Right emerged from Solidarity. As economic conditions deteriorated and a recession enveloped the nation in 1990, nationalist, chauvinistic, fundamentalist Christian, anti-Semitic, and fascist tendencies took center stage. A xenophobic

economic, social, and political challenges beyond its capability.

paralysis gripped some Solidarity factions. The downfall of the totalitarian state permitted all the phobias, conflicts, and discrepancies that had been suppressed or concealed for 40 years to surface (Goszczyński 1990a). Rightist Solidarity members demanded the spoils of victory and compensation for past injustices. The Right became instrumental in the purging of former Communists from positions of power but could not deliver the expected economic benefits.

Walesa, as the leader of Solidarity, initially supported the Mazowiecki government. But in 1990, his support began to wane. He became disenchanted with the pace of reforms and the government's lack of initiative to cleanse society of the former nomenklatura (Cydejko 1990a; Majman 1990a).

When Walesa decided to run for president in the fall of 1990, he took his campaign to the people, promising accelerated privatization and a complete reckoning with the nomenklatura. He never made it clear how he would accomplish the latter task since three million members of the PUWP appeared to have vanished overnight. When the PUWP was defeated, Polish professionals, who had joined the PUWP to advance their careers, abandoned the party in droves. These professionals could not all be purged, especially since many Solidarity leaders had been PUWP members.

Another early campaign promise included the dismissal of Balcerowicz, but as the election approached, Walesa's rhetoric regarding Balcerowicz changed. When he became president in November 1990, there was no doubt that Balcerowicz would remain. Balcerowicz's presence was required to allay fears of foreign economic interests and to continue the economic reform. Although Walesa's pre-election rhetoric focused on changes, his economic program did not differ significantly from the Balcerowicz Program (Klosowski 1990).

Mazowiecki and Centrist Solidarity Factions

Support for Mazowiecki and his government was transitory. Early in 1990 support began to wane as the Balcerowicz Program brought hardship and privation to the nation and Mazowiecki cautiously proceeded with privatization. A search for the source of the nation's difficulty was placed on the Communists, and demands for purging surfaced. The Mazowiecki government was clearly against settling accounts with former PUWP members, but this policy was at odds with social expectations even though there was a recognition that avenging wrongs would delay the political and economic transformation and that governing would be impaired (Majman 1990b). Although the Mazowiecki government and later the Bielecki government spurned the vetting of Communists, it became an all-consuming issue with the Right and had to be addressed. On 6 July 1990 amidst

mounting political tension and social unrest punctuated by nationalistic and populist tendencies, Mazowiecki made changes in his cabinet to eliminate the last remnants of the coalition cabinet formed as a result of the Round Table (Cydejko 1990b; Zmijewski, Dubrawska, and Cydejko 1990). The centrist position opposed the speedy elimination of the old nomenklatura, believing that if the nation chose to concentrate on the hunt for former Communists, social anarchy would prevail; the centrist factions also opposed the acceleration of privatization, believing that hastening would increase disenfranchisement (Debecki 1990). Yet the centrists stressed the importance of continuing the Balcerowicz Program and the development of democratic principles in all domains (Goszczyński 1991a).

The Solidarity Left

At the beginning of the liberalization process, association with the Left meant post-communist affiliations. As the pauperization of the nation continued and unemployment traumatized the workers, leftist tendencies no longer remained the exclusive domain of the post-communists. By 1991 a Solidarity-based leftist faction began to appear that supported the interest of farmers and employees of SOEs. They voiced concerns over social justice and the declining purchasing power of the worker and demanded increased social security measures (Goszczyński 1991b).

Solidarity, the Union

Most of the members of the trade union did not view the politicization of Solidarity favorably. The fragmentation of Solidarity took its toll on the trade union as membership diminished. In 1991 the membership elected Marian Krzaklewski to succeed Lech Walesa as chairman and voted for less political involvement (Goszczyński 1991d). Krzaklewski also pledged to create a regional structure that would fight an excess wages tax (popiwek) and continued opposition to any alliance with the post-communist OPZZ trade union.⁴²

The movement to overthrow communism was successful, but the opposition inherited an economy in ruins. Difficult decisions had to be made, and the Solidarity leadership was ill-prepared and unable to generate consensus on legislative issues that would facilitate the establishment of a democratic state and a transitional economic policy not tied to IMF and World Bank dictates. Once the euphoria of victory subsided, discord prevailed as economic hardships increased. Once the PUWP was dissolved, the thread uniting the opposition disappeared, and political turmoil prevailed. By September 1990 there were over 80 registered political parties, each with its own agenda (Cornell 1991).

⁴²Alfred Miodowicz was head of the OPZZ Trade Union with a membership of 6.5 million. The OPZZ Trade Union emerged ten months after the implementation of martial law in 1981 when Solidarity was made illegal (Cydejko 1991a).

The Emerging Democratic State

Poland is a classic case where the overthrow of a tyrannical government leads to a refusal to put any limitations on democracy. The result is political anarchy, the inability to gain needed consensus among fragmented splinter groups. Needed reforms do not occur, and people become disenchanted with the democratic process.

Evidence of this phenomenon appears in the election results. During the 1990-1991 period, Poland held three major elections: a local self-government election, a presidential election, and a parliamentary election. With each election, voter participation and support for Solidarity decreased.⁴³ As disinterest in politics engulfed the populace, political turmoil increased.

Difficult political reforms took precedence over economic reforms; yet, with no parliamentary consensus, even political reforms were difficult. Constitutional reform, a prerequisite for all political reform, did not occur until 1992, and only in a modified form with the promulgation of the "small constitution."⁴⁴

⁴³See Dubrawska (1990) for a discussion of the 27 May 1990 local elections. The election was the first democratic elections of post-World War II Poland. Observer teams from the European Council monitored these local self-government elections. For a discussion of the fall 1990 presidential elections, see Goszczynski (1990b). See Goszczynski (1991c) for the results of the fall 1991 parliamentary elections.

⁴⁴Work had commenced on a new constitution at the beginning of the transition, but the sweeping changes in the political landscape sharply curtailed agreement on the

At the time of the first privatizations in 1990, Poland did not have a viable state sector, one capable of managing the transformation process. As the shares of the first publicly traded companies were being sold, Poland did not have a ruling government. Mazowiecki had resigned, and Bielecki had not yet formed his coalition government.

Successful privatization required not only the establishment of an effective state to replace the communist bureaucracy, but it also required dismantling of communist monopolies in publishing and telecommunications to promote democratization and economic reform. Official censorship of the press ended in June 1990 and parliament passed the Act on Telecommunications in January 1991, which broke up the monopoly that the state held over radio and television. Because of ill-defined ownership rights of the airwaves, the law was ineffective until amendments to the law were made in December 1993, with final resolution in 1994.

Changing Social Attitudes

Before a democratic state could emerge, the Sejm first had to dismantle the communist control organization, which included the Ministry of the Interior and the military to address popular resentment of oppression and human rights violations and to establish a new independent, protective

constitution. Although work on the constitution continued, the issues became vague as personalities emerged with their own vision of Poland's future. The "small constitution" was a stopgap measure, a temporary document.

organization that people would trust.⁴⁵ The military, the Ministry of Internal Affairs (police), and the Ministry of the Interior (secret police) remained symbols of communist persecution. None of the groups gave up power voluntarily, and economic reforms languished as the Sejm struggled to enact reforms that would divest the nomenklatura of power.

At the onset of the democratization process the urgency of economic problems compelled the Communists to liberalize political power. Once political liberalization commenced, the task was so overwhelming because of the lack of a fully functioning state that difficult economic reforms lagged.

Because little changed for the better, the reality of market reforms alongside the political chaos very quickly diminished popular support for the changes. Radical changes

⁴⁵The Ministry of Interior was probably the most detested ministry during the communist period because of its clandestine operations and human rights violations. It included the militia, the security service, border guards, special riot units, the fire department, counter-intelligence, antiterrorist brigades, the industrial guard, and intelligence and police schools. A special Sejm commission was set up to investigate the activities of the ministry and to restructure various departments to ensure human rights protection (Cydejko 1990c).

Major changes in the military were made. Reforms went beyond simply changes in ideology. The military had been organized around both defensive and offensive objectives. Membership in the Warsaw Pact demanded military capabilities that would allow incursions far beyond Poland's own borders. With the disintegration of the Warsaw Pact, political reality changed. In March 1990, the National Defense Committee prepared a document that laid out Poland's military position as only defensive. The document condemned the exploitation of Polish soldiers in actions against other nations and declared that the Polish armed forces were a sovereign member of the Warsaw Pact capable of making their own decisions (Zmijewski 1990).

in attitudes were required from workers, yet when the benefits of economic reform did not materialize, workers' support for the reforms dissipated.

Polish political scientist Zukowski (1990) found that workers believed that privatization would result in capitalism with a human face. The Polish people assumed that changes would be just and fair. That utopia never materialized. Zukowski concluded that the public supported capitalism in theory but not in practice. The harsh realities of everyday personal existence created increasing dissonance between the promises that the reformers had made and the economic circumstances of most Poles.

Gardawski (1991) conducted a longitudinal study of workers' attitudes that supported Zukowski's (1990) results. He found that when asked about job and workplace preference, the answer was the same in 1987 and 1990. Sixty percent of Polish workers preferred work in a SOE. Support for privatization waned as the perceived inequities among the populace increased.⁴⁶

At the beginning of the transition, the populace placed enormous trust in Poland's leaders. A survey conducted by the Public Opinion Research Center (CBOS) indicated that 80%

⁴⁶Weisbrod (1978) suggests that an envy effect follows a reallocation of resources when there is a perceived loss that is greater than expected. As the redistribution of resources in Poland proceeded, workers began to object to the ensuing inequities and judged the changes as undesirable.

of those polled viewed Mazowiecki, Walesa, and Poland's Primate, Cardinal Glemp, favorably (Uznanski 1990). By September 1990, one year after the Solidarity-led Mazowiecki government took office, popular support for the government had declined significantly. Unresolved issues with respect to unemployment, agricultural policy, and deteriorating social conditions headed the list of dissatisfactions (Uznanski 1991).

Declining public support for economic reform is not surprising in that privatization had the immediate impact of increasing poverty in Poland and generating large inequities in income. The Central Statistical Office (GUS) found that approximately 39% of the population lived below the poverty line in 1992 compared with 20% in 1990. Food, while more plentiful, had become a matter of concern as 43% of Polish households had to cut expenses in other areas to buy food. As unemployment skyrocketed, approximately 20% of these households had to borrow money to purchase food, and 16% ceased paying monthly bills for utilities and rent.⁴⁷

⁴⁷Since Poland had no eviction law, the populace could cease paying rent without dire consequences. The failure of the Sejm to enact banking and eviction laws at the onset reflected the difficulty of switching from a communal to a private property system until a social net could be established (Styczek 1993d).

Poland's most pressing problems in 1993 were unemployment and poverty.⁴⁸ Poles had a roseate view of capitalism; the insecurity of a market economy came as a shock to many. The rapid change initially advocated by many reformers generated strong resistance from the workers who had led the revolution. Sociologist Jerzy Wertenstein-Zulawski (1993) found that after four years of Polish transition only 20% of the population felt they had benefitted from economic reform, while 50% felt bewildered by the changes and 33% felt irretrievably harmed.

Summary

In 1989 Poland began a political and economic transformation process that liberalized political and economic activities in the country. The liberalization, however, impoverished many people and destroyed entire industries. The difficulties with the Balcerowicz Program and the neoclassical economic approach to the transformation were not unexpected. The overlay of a market economy on a CPE was not a viable approach to changing the system. It did not work because there was no legitimate state to facilitate the economic change.

⁴⁸An estimated 1,000,000 people were unemployed by October 1990. According to Jerzy Paculski (1990, 11), director of the Employment Department of the Ministry of Labor and Social Policy, "We are completely unprepared to deal with unemployment, both as a nation and as a ministry." Nine months later 1,749,867 were unemployed, approximately 9.3% of workers (Dukaczewski 1993; Sosnowska-Smogorzewska 1991).

The transformation included a political transition that created discord and dysfunctionality. The dissolution of the PUWP and the fragmentation and, finally, the collapse of Solidarity contributed to an ineffective state, paralyzed by its efforts to be fully democratic. While the austerity of the economic reforms contributed to the political chaos, the lack of political consensus allowed the economic program to continue on its austere course. The threat of losing funding for the transformation propelled the government to take certain measures that appeared "market-like," such as the privatization of SOEs. Yet, without the institutionalization of a legitimate state, well-defined property rights, market institutions, and laws, many of the changes were cosmetic. Moreover, the cultural reorientation of workers was ignored. It was assumed that workers would adapt to the new market-based institutions. The power of the inculcated communist work ethic was underestimated. In market economies people are socialized to accept "value efficiency," where the work is done in the most expeditious manner. Polish workers had no such socialization and had difficulty accepting the new standards. The new reality, defined by the cultural importation of Western accounting principles, demanded that labor work harder and accept greater uncertainty regarding job security and relatively less wealth.

If one examines the environmental factors that, according to Choi and Mueller (1978), are deemed necessary for implementation of a sophisticated Western accounting system, then Poland remains at an embryonic state (see table 1). Past reliance on central planning with the development of an industrial sector based on a dysfunctional COMECON market limits the application of Western accounting principles. A rapidly evolving political and legal system in the throes of divesting itself from the constraints of the preceding system, along with the lack of a well-defined and functioning private property rights system, makes imposition of Western accounting valuation methods questionable. The volatile social and economic climate precludes the wholesale incorporation and institutionalization of Western accounting principles developed over time for an established market-based system.

CHAPTER 3

PRIVATIZING THE ECONOMY

Introduction

An antiquated legal system created significant barriers to establishing a market economy in Poland. Initially, the most troublesome issues were the inability to transfer profits to foreign investors; bureaucratic impediments; lack of a market infrastructure, particularly in banking and telecommunications; and economic volatility. Although the new system allowed foreign capital investment, lack of consistent interpretations of the law and excessive bureaucratic practices thwarted increased participation by foreign investors.⁴⁹

The economic recession in 1990 created a demand barrier on the domestic market, an ironic turn, since only a year earlier store shelves were empty because demand far outstripped supply. State-owned enterprises (SOEs) reacted and began to undertake increased exporting activity to reduce their surplus products. Pietrzyk (1990) described

⁴⁹In 1990 opening a casino in Poland required four permits: (1) from the Foreign Investment Agency allowing the formation of a joint venture, (2) from the Ministry of Finance approving the business, (3) from a bank to allow foreign currency exchange, and (4) from the Polish Lottery Monopoly authorizing the gaming. See "Orbis Casino, Bet on Central Europe," Warsaw Voice (17 June 1990, 8).

the business climate as a "free-for-all" as enterprises artificially lowered prices to sell regardless of manufacturing costs. Employment was still the primary objective of SOEs. The value-decreasing culture had not changed.

The demand barrier impacted the private sector as well as the state sector. The newly created private sector, inexperienced and underfinanced, and consisting of mostly small service and production companies, suffered major setbacks in 1990--102,000 companies were liquidated while another 120,000 were on the verge of bankruptcy. Over 320,000 new businesses emerged, but most were trading companies. The crisis in the manufacturing sector became acute when Poles spurned domestically produced goods in favor of imported foreign products (Pietrzyk 1991). After years of forced deprivation, Poles chose foreign-manufactured products over domestic ones regardless of the quality.

Political, not economic, factors had determined the pattern of development of Polish industry. Compared to world standards, Polish enterprises during the Communist era were small, but because most held a monopolistic position, they survived irrespective of efficiency or quality of products. All goods could be sold in the domestic market or to the Soviet government. Additionally, since enterprises had to adapt to a supply-deficient economy, even small

enterprises maintained their own repair shops and machine shops to build their own machinery. The SOEs also had to provide employee housing, transportation, and vacation centers. Wellisz (1990, 13) noted that the desire to provide total security to employees led to some strange associations. He suggests that their "crowning achievement was organizing breeding farms next to industrial plants. Now that is really absurd--to have a steel-mill breed pigs!" Cradle-to-grave security could not be maintained in a market setting nor could value decreasing enterprises survive when subsidies ended.

The first major signs of industrial collapse appeared in 1991 when a report concluded that enterprises unable to repay bank loans had grown from 30% to 45%. Furloughs of workers became inevitable as sales in the domestic market declined and the Soviet market collapsed.⁵⁰ Privatization was viewed as the overall solution to the economy's and the industrial sector's difficulties. As financial dissolution seemed imminent, the government increased the pressure to privatize amidst a new political reality in the Sejm.

The Privatization of Economic Activities

The privatization of the Polish economy began in 1988, long before the implementation of the Balcerowicz Economic

⁵⁰See "Business Brief," Warsaw Voice (31 March 1991, 5) for a discussion of the layoff of workers at the Ursus Tractor Plant in Warsaw.

Program or the promulgation of the law on privatization in July 1990. Privatization was viewed as central to Poland's economic development, even by the Communist party. When political liberalization occurred with the June 1989 elections, privatization became the agent for change.

The early privatization, called the "little privatization," began with small retail stores. Although a few stores were reprivatized, where ownership could be clearly established, employee takeovers accounted for most retail privatizations. By the fall of 1991, most of the nation's retail stores had been privatized (Styczek 1991).

Shortly after Mazowiecki became premier in 1989, he appointed Krzysztof Lis to the new position of plenipotentiary for Ownership Changes. Lis's primary tasks were to coordinate all privatization activities and to develop a plan for ownership changes in the state sector. The process of privatization proved to be far more complex in the large industrial sector than in the retail sector. Conflicting claims between those who owned property that had been confiscated in 1945 and workers who claimed ownership of SOEs had to be resolved. Since all businesses had been depicted as communal for 45 years, employees felt that they had an ownership interest. Workers argued that they had accepted low wages for years to provide capital for SOEs. Now, they argued, they should be compensated for their capital investment.

The privatization plan drafted by Lis that passed parliament in July 1990 consisted of two laws, one that set up the Ministry for Ownership Changes and one that recognized the legitimacy of workers' claims. Lis had mixed feelings about the wisdom of recognizing those claims; he viewed workers' claims as the biggest obstacle to successful privatization.

The fundamental issue was one of equity. While workers of an SOE had a legitimate claim to ownership, all citizens had made sacrifices during the communist era to support favored industries. Because the central government determined which SOEs received the most generous subsidies and most advanced technology, some SOEs simply were more valuable than others. The value of an SOE had little to do with employee efficiency, rather it stemmed from the largesse of the central planning agency. Capital funding came from the taxes imposed on all SOEs; all workers in all sectors received low wages and made sacrifices. There appeared to be no moral justification for allowing those who happened to work for the best SOEs to reap all the benefits of privatization while those who worked for resource-starved SOEs received nothing. Thus, privatization efforts had to balance the preferential rights of the workers of SOEs with the rights of all citizens to have access to the nation's communal assets (Goszczyński 1990c).

Privatization Legislation

The draft laws on privatization were ready in February 1990 but passage of the laws did not occur until July 1990. Parliament, preoccupied with the May 1990 local elections, did not turn its attention to privatization until after the elections. The first law established the Ministry of Ownership Changes. The second laid out the direction of privatization for SOEs.⁵¹ Additionally, the privatization laws were based on the forms of ownership set up in Poland's 1934 Commercial Code as amended in 1988 and 1990.⁵² Acceptable legal forms for transformation were the joint-stock corporation and the limited liability corporation as defined by the code.⁵³

⁵¹Privatization was based on two laws. The first, Act Establishing the Office of Minister of Ownership Changes, provided the ministry with legal foundation. The second, Act on Privatization, outlined the methods. Both were reprinted in Rzeczpospolita (23 July 1990, III-IV).

⁵²The code was updated with the promulgation of the Commercial Code Amendment Act of 23 December 1988, reprinted in Dziennik Ustaw, No. 41, 1988, and the Commercial Code Amendment Act of 24 February 1990, reprinted in Dziennik Ustaw, No. 17, 1989.

⁵³Capital share is the greatest distinguishing feature between the two corporate forms, with the joint stock company requiring an investment of at least 250 million zlotys and the limited liability company, only 10 million zlotys.

Privatization by Commercialization

The 1990 law provides two distinct methods of privatization, commercialization and liquidation.⁵⁴ In the case of commercialization, the Minister of Ownership Changes commences the process at the initiation of (1) a joint request from the Workers' Council and the managing director of the enterprise after conferring with the employees and the founding body; or (2) at the request of the founding body with the consent of the managing director and the Workers' Council after consulting with the employees.⁵⁵ Submission of a request must include an economic/financial assessment of the enterprise, draft articles of incorporation based on the Commercial Code, and the proposed preferences for employee stock purchases. The Minister for Ownership Changes can deny the request either because of the SOEs poor financial condition or because he/she deems the privatization of the SOE to be contrary to the state's interests.

Privatization begins when the enterprise is said to be a solely-owned company of the state treasury. The closing

⁵⁴The three companies examined in chapter 5, Krosno, Prochnik, and Tonsil, have undergone the commercialization process.

⁵⁵The founding body is a hold-over term from the central planning system. It represents the authority (ministry, other central government agency or local authority) that has administrative control over an SOE. All major business decisions of the SOE are referred to the founding body for approval.

balance sheet of the SOE becomes the opening balance sheet of the privatized company. The sum of the assets and enterprise operating funds become the capital of the corporation, divided according to law between the registered capital account and the reserve capital account. Before shares are issued, the Minister of Ownership Changes, with the consent of the Minister of Finance, can assume part or all of the company's debts on behalf of the state treasury. After a treasury-held company is offered to investors, the company has to adhere to accounting principles promulgated by the Ministry of Finance. Until that time, principles of SOE accounting prevailed.

A commercialized company must have a management committee and a board of directors. The management committee of the corporation is required to publish an audited balance sheet and profit and loss statement in a daily newspaper. Employees elect one-third of the board of directors. Although this stipulation can be changed, it cannot be done while the state treasury owns at least half the authorized shares.

The privatization law requires that preferential treatment be given to the employees of the SOE. Commercialization cannot occur without the consent of the employees, and once privatization begins, employees are entitled to buy 20% of the authorized shares at a 50% reduction of the original selling price. The commercialized

entity must keep these preferential shares in reserve for a maximum of one year from the issue date or until sold. The state treasury holds all shares that have not been purchased and can assign ownership rights to a bank, but any revenues that accrue from the stock must be returned to the state treasury.

Privatization by Liquidation

The other form of privatization allowed by the privatization law is liquidation. Privatization by liquidation includes three variants: (1) the sale of the enterprise or part of its assets, (2) the contribution of the assets in part or in their entirety to another company, and (3) the leasing of assets. In the case of liquidation, the process is initiated by either the founding body or the workers' council with the consent of management and the employees.

The First Official Privatization

In the first half of 1990, over 100 SOEs declared an interest in privatization. At the time it was anticipated that Kable, Exbud, and Prochnik would be the most likely candidates for the first public offerings through the Ministry of Ownership Changes.⁵⁶ The privatization of

⁵⁶The three enterprises represented diverse industries. While Prochnik is a clothing manufacturer, Kable manufactures a wide assortment of cables, and Exbud is a construction company.

Wedel was anticipated in the near future, but conflicts among various stakeholders at Wedel made privatization problematic.⁵⁷ The managing director, Andrzej Karboniczek, suggested that the SOE Wedel cease to exist while the plant became a partnership between the employees (20%) and the treasury. The factory's Solidarity trade union refused to agree to privatization under Karboniczek; accusing the director of being the oldest representative of the nomenklatura in Poland. Karboniczek had been director of Wedel since 1967.⁵⁸ By the time Wedel's shares were offered to the public on 22 October 1991, Karboniczek was no longer the managing director and PepsiCo Inc. was a major investor, with James O'Neal of Frito-Lay as the chairman of the board of directors.

On 27 September 1990 the Ministry of Ownership Changes took its first major step. The "Magnificent Seven," a name attached to the first seven enterprises privatized according to the law on privatization, were set up as wholly-owned companies of the state treasury. The group included Exbud, Kable, Prochnik, Fampa, Norblin, Krosno, and Inowroclaw.⁵⁹

⁵⁷Wedel is a renowned Polish producer and retailer of confectionery products.

⁵⁸See "Wedel Goes Private, Bittersweet Experience," Warsaw Voice (26 August 1990, 12), for a discussion of difficulties encountered between an SOEs post-communist management and workers.

⁵⁹Fampa, Norblin, Krosno, Inowroclaw, Swarzedz, and Tonsil were all considered Poland's best SOEs. Norblin, also known as the Warszawa Metal Mill, manufactures copper,

All the enterprises except for Inowroclaw, which became a limited liability company, eventually became joint stock companies. Swarzedz and Tonsil also had been on the original list, but because of difficult negotiations with their workers, their privatizations were delayed (Cydejko 1990d).

When the public subscription of shares began on 30 November 1990 on the eve of the presidential elections, the situation had changed again as Tonsil joined Exbud, Kable, Prochnik and Krosno to become the first five SOEs to be privatized through a public offering. The sale of shares of the first five enterprises offered to the public took place at a selected number of banks. Although the sale of shares was scheduled to end on 21 December 1990, the inability of the banking system to manage the sale required the Ministry for Ownership Changes to extend the deadline to 11 January 1991. According to a Polish government poll, the reason for the high demand for shares was investors' expectations of large future dividends (Gajewska and Cydejko 1991).

At the end of 1990 the Polish government presented its program on the privatization of the economy. The scope of the privatization effort extended well beyond the 1990 law, including an additional major program, mass privatization.

silver, aluminum, and tin industrial products; Fampa, industrial machines for paper production; Krosno, glass products; Swarzedz, furniture; and Tonsil, speakers. Inowroclaw is a meat packing plant.

The hope was that mass privatization would not only accelerate the privatization of 500 of the country's largest enterprises, but would also foster the development of a sectoral approach to privatization and the creation of secondary market institutions (U.S. Department of Commerce 1990).

Privatization proceeded more slowly than anticipated; by 31 August 1991 less than 10% of the over 8,000 SOEs had begun the process. By August 1991, 556 SOEs had been liquidated and almost 200 enterprises were in ownership limbo. These 200 enterprises were set up as companies of the state treasury. Although ownership had changed hands for these enterprises held in trust by the treasury, all were in great financial distress. By 30 September 1993, 3,637 SOEs had begun privatization, with the number of liquidations far outnumbering the number of commercializations (see table 3).

Management had opted for privatization as a means of relieving part of its financial obligations to the state. Management hoped that the state would take care of the restructuring with subsidies and economic assistance. They perceived privatization as a means of prolonging government assistance and support. It was a way of maintaining the status quo. By fall 1991, it became clear that the government could no longer count on the transformation

process to occur without state intervention. The best Polish companies had been either privatized through joint

TABLE 3
NUMBER OF SOEs ENTERING THE PRIVATIZATION
PROCESS EACH YEAR BY TYPE

Date	Total	Commercialization	Liquidation	Agriculture ⁶⁰
12/31/90	130	58	72	--
12/31/91	1,128	250	878	--
12/31/92	1,220	172	509	539
9/30/93	1,159	96	359	704

Source: Compiled from Prywatyzacja Przedsiębiorstw Państwowych, Privatization of State-owned Enterprises (Warsaw: Główny Urząd Statystyczny, 1994).

ventures with foreign investors or through purchases of stock from the state treasury in accordance with the law on privatization.

The Minister of Ownership Changes Janusz Lewandowski emphasized the increased need for government involvement. According to Lewandowski (1991, B5):

the active role of the state in system transformations is unavoidable. A clear definition of the role and powers of individual ministers in this process is essential, as is the better coordination of the activity of all existing institutions. The Agency for Structural Change, the Polish Development Bank, and the Corporation for Export Credit Insurance all must help support the changes.

⁶⁰Special provisions were promulgated for the privatization of state-owned farm land.

Mass Privatization Program

The initial calls for a mass privatization program came during the fall 1990 presidential elections. Walesa, unhappy with the slow progress of privatization, promised an accelerated program that would transfer the nation's wealth into the hands of every Polish citizen by means of mass privatization.

After the first official privatizations occurred in fall 1990, it became clear that there was not sufficient domestic capital to privatize all large SOEs through conventional means. The government devised a program that would place privatized SOEs into national investment funds similar to a mutual fund, with the commercialization of approximately 300 enterprises scheduled for 1991 and 200 in 1992. The program was overly ambitious and did not materialize until 1996 in a very different form than originally proposed.

The deterioration in overall economic conditions, the financial distress of many SOEs, the perplexity of valuation issues, and the volatile political situation delayed the implementation of the program. Political dissention delayed passage of the mass privatization program in the Sejm until 30 April 1993. Difficulties with valuation, obtaining adequate accounting data, and the financial solvency of the SOEs in the program further delayed implementation. In general, the companies selected for mass privatization were

companies that were not good candidates for a public offering or for foreign investment (Pawlowski 1992). Most have had serious problems with liquidity; therefore, the program has been tied to the concept of National Investment Funds (NIFs). The shares of the various companies participating in the mass privatization program are allocated to 15 NIFs, whose role is to manage the assets of the companies in the fund. The burden of profitability is placed upon the managers of the NIFs. Lack of financial expertise has necessitated reliance on foreign managers for assistance and has further delayed implementation.

Sectoral Privatization

The sectoral approach was based on the premise that it is easier and less costly to privatize a group of companies in the same industry at the same time. Initially, the Ministry of Ownership Changes identified twenty industries (see table 4) and a consulting firm was chosen for each sector. The task of each consultant was to develop a domestic and an international perspective of the industrial sector, identifying potential investors and defining strategies to increase the profitability of individual companies and the sector as a whole (Ministry of Ownership Changes 1992). The first five major industries participating in this program were breweries, cement, detergents and personal care, machine tools, and shoes. Sectoral privatization continues as other industries are

TABLE 4
LIST OF SECTORS AND THE NUMBER
OF SOEs ASSIGNED FOR
PRIVATIZATION

SECTOR	Number of SOEs
Building	24
Cement and lime	26
Confectionery	18
Electronics	10
Power equipment	2
Paint and lacquer	5
Technical gases	8
Tires and rubber products	8
Cables and wires	10
Cosmetics and detergents	2
Ball bearings	4
Furniture	53
Mechanical and electrical motor companies	25
Meat processing	23
Machine tools	6
Shoes	3
Pulp and paper	6
Breweries	8
Glass	26
Tobacco	6

Source: Ministry of Ownership Changes, Privatization Update (1992 October, 4).

targeted and more SOEs are added to the list for privatization.

The Secondary Market

In the first two years of the transition, no formal mechanism existed for securities trading. The doctrine of caveat emptor ruled. Securities of companies such as Drewbud and Universal and second-issue government bonds increased activities for banks, exchanges, brokers, and independent jobbers. Since trading of these securities was not regulated, swindles were not unusual. In late 1990, regulation of securities trading began concurrently with the public trading of SOEs privatized under the 1990 law.

The Warsaw Stock Exchange opened on 16 April 1991. The first five enterprises sold to the public in 1990 entered the exchange. The first day of trading was declared a success as shares of each company changed hands and share values increased from their original subscription prices.⁶¹ The stock exchange, however, commenced operations without a securities commission and legally licensed brokers because of delays in the passage of laws (Sowinska 1991c).

Prices on the stock exchange decreased throughout the summer of 1991 and continued the downward trend through 1 October 1991. Chalupec (1991, B7) attributed the lackluster

⁶¹Since most buyers purchased shares with state bonds which provided the buyer with an immediate 20% discount, the value of all five companies increased on 16 April.

1991 performance to (1) the unstable political situation, (2) the chaos in parliament caused by the upcoming parliamentary elections, (3) the deteriorating economic conditions, (4) the ever-increasing budget deficit, and (5) the continued absence of a central bank president. The market continued its decline until June 1992. Commencing with trading in July 1992, stock prices increased over the next 21 months creating a small bull market.⁶²

The Polish Securities Commission

The Act on Public Trading of Securities was passed by parliament on 22 March 1991 providing the legal basis for the establishment of the securities commission, operation of the stock exchange, and the creation of a stock brokerage profession. The Polish Securities Commission (PSC) was created in April 1991 to regulate the sales of all securities to the public. The legislation creating the PSC provided protection to buyers, a necessary first step in implementing mass privatization (Buczek and Grzedzinski 1991). At the time of the PSC's inception, the five companies that had been privatized in the fall of 1990 and publicly sold in December 1990 came under its jurisdiction.

The public trading act outlined the scope of civil and criminal obligations for securities infractions, which

⁶²In 1991 there were nine companies listed on the exchange. By 1993 there were 22 companies. Seven had been privatized in 1992 and six in 1993.

prohibited dissemination of false information in a prospectus, insider trading, and operating mutual funds without a permit. The act empowered the PSC to represent the interests of the public where transgressions occurred. As the capital market developed, additional legislation was needed to monitor the growth, and amendments were made to the Act on Public Trading (1991, 1993, 1994). The legislative changes made in 1993 were aimed at modifications to conform to European Community (EC) regulations.

The PSC was given the task to authorize all public sales of securities, license brokerages and monitor their activities, regulate the market and promote its development and stability. The chairman of the PSC viewed the task as formidable because of "the lack of any experienced practitioners, the particularly strong need to protect inexperienced investors and the poor infrastructure of technology and telecommunications" (Paga 1991, 3).

A Decree of the Council of Ministers in 1991 established official prospectus requirements for companies going public. The requirements were based on what was perceived as an adequate and accurate disclosure of material facts, requiring the issuer to provide detailed information, including accounting reports, about the issuer and the proposed securities. Although the decree established a legal basis for the prospectus, the information that the PSC required was similar to the guidelines established by the

Ministry of Ownership Changes. The decree formalized the prospectus requirements and placed oversight control over companies intending to go public under the jurisdiction of the PSC.

Foreign Investment

From the beginning, the Mazowiecki government stressed the need for foreign investment, and each subsequent government lamented the lack of foreign investment. Although foreign businesses were anxious to enter the new Polish market, sociopolitical barriers existed that made foreign investors reluctant to make large capital investments to modernize Polish industry. These barriers included (1) bureaucratic difficulties, (2) inadequate telecommunications, (3) an antiquated banking system, (4) poor transportation, (5) an incomprehensible legal system, and (6) political uncertainty.

At the beginning of the transition, Poland attracted some foreign investment, but not the significant amounts needed to quickly rehabilitate the industrial sector. When foreign companies invested in the privatization process, there usually were two reasons for their early involvement-- previous ties through technology sales or products easily sold on the domestic market. Some Polish enterprises had purchased technology from the West, and this relationship resulted in joint ventures. In other cases, foreign

investors found Poland's strong domestic market attractive.⁶³ A review of early privatizations and reported joint ventures indicates that reforms, designed to attract foreign investment, were successful only in those areas that had immediate profit potential. Overall, foreign investment was cautious, reluctant to commit to restructuring industries and willing only to invest where short-term profits were apparent.⁶⁴

The lack of a Polish legal framework defining the scope of foreign investment and guarantees regarding property rights were important impediments to increased foreign investment in the early transition period. Eventually, Polish law established seven distinct methods of privatization for foreign investors, which were defined

⁶³Past associations, such as Polam Pila with Philips, Polkolor with Thomson Consumer Electronics, and various Polish SOEs with Asea Brown Boveri, resulted in joint ventures. Other developments included foreign investments in areas of good market potential: Wedel and Pepsico, Telfa and AT&T, Pollena Bydgoszcz and Unilever, and Pollena Raciborz and Henkel.

⁶⁴Early in the transition it was observed that management training was an essential element in the process of transforming the economy. Assistance was sought from Western Europe, the United States, and Japan. Identification of specific areas presenting difficulties included banking, finance, and accounting.

An agreement with the French government provided training for 600 managers over a two-year period. The British government set up a 50 million pound endowment called the Know How Fund. The fund was designed to provide vocational and professional training for Polish specialists. Programs were set up to provide internships for Polish professionals in British firms and banks, and seminars were held in Poland to educate lawyers, bankers, accountants, and journalists.

within the scope of three laws: Act on Companies with Participating Foreign Subjects, Act on Privatization, and the Act on State Enterprises (Polish Government 1991, 1990, 1981). But it took time to understand the implications and repercussions of each law within the volatile political-economic environment. Foreign investments could only make an impact once foreign investors felt that they could make a profit in Poland and differences between management and employees could be resolved. On 30 April 1996 the State Foreign Investment Agency reported that, since 1990, foreign investments exceeded \$8 billion, but much of the amount can be attributed to the most recent years including an investment in excess of \$1 billion in the first quarter of 1996.

Based on the Act on Companies with Participating Foreign Subjects (Polish Government 1991), the first method establishes a joint-venture company. The joint venture is created with a principal from the foreign partner and the director of the enterprise with the consent of the workers' council. The Ministry of Ownership Changes must approve the final plan. Once permission is granted, a contract is signed enumerating the conditions of the joint venture.

The Act on Privatization (Polish Government 1990) provides a foreign investor with the most options: (1) purchasing of stock from the state treasury, a primary market transaction; (2) purchasing a second-issue stock; (3)

leasing liquidated enterprises; (4) establishing a company in partnership with the state treasury; or (5) purchasing assets of a liquidated enterprise. In each case, employees must receive up to 20% of the stock of the new venture.

This privatization process creates a conflict of interest between political and economic objectives in four of the five strategies. With the exception of the second variant, the state receives the cash raised from privatization or has an ownership interest in the company. While variants one and five provide the state budget with an immediate inflow of cash, variants three and four allow for state ownership, with a future potential for cash inflow to the state budget. While the state budget is fortified with cash either immediately or some time in the future, only the second variant provides the enterprise with additional capital unless the state treasury negotiates a promise from the investor--foreign or domestic--to provide additional capital investments in the future.

When a foreign investor purchases stock from the state treasury, it is with the permission of the Ministry of Ownership Changes. The proceeds from the purchase of the stock remains in the state treasury and do not flow to the company. In this case, there is usually an agreement that other funds from the investor will be used for modernization and investment projects and that one-third of the seats on the board of directors will represent labor.

The purchase of a secondary stock issue provides some advantages over the direct purchase of stock from the state treasury. The money received for the stock increases the company's capital stock and also increases its cash position; however, if the company is still owned by the state treasury, the benefits of the second issue accrue to the treasury and not to the company.

Leasing a liquidated enterprise represents another possibility for investment if the enterprise's founding body or workers' council decides to liquidate. However, the founding body must agree to the decision. The Ministry of Ownership Changes can obstruct the liquidation process if it is not in agreement with the founding body. The main advantage of leasing is reduced risk. The amount of initial capital required is considerably less than the other options because lease payments are spread over time. The disadvantage of leasing a liquidated enterprise is the lack of ownership rights; the state treasury remains the legal owner of the enterprise.

The establishment of a company with the state treasury presents a fifth method of foreign investment. Similar to leasing, the founding body or the workers' council recommends liquidation. Once the decision to liquidate is made, the founding body can establish a state treasury company with an outside party. The consent of the Ministry of Ownership Changes is required in order for the assets of

the liquidated company to be used in the new company. The main advantage of this method is that the state treasury participates in the process and can help to resolve any problems with management or labor.

The final variation permitted under the Act on Privatization (Polish Government 1990) allows for the purchase of assets of a liquidating enterprise. In this case, the enterprise does not become a state treasury company. The assets are sold either in their entirety or in part to an investor. The advantage of this method is that there is an acquisition of ownership rights, but the disadvantage is that the state treasury receives all the money paid for the enterprise. The investor must have excess cash to prop up the new enterprise.

If the failing enterprise has been declared bankrupt, then the Act on State Enterprises (Polish Government 1981) allows the structural fund of the industry to take over the bankrupt enterprise without the approval of the founding body or the workers' council. Bankrupt companies can be purchased at very low prices, but since resolution of bankruptcies requires a complex and lengthy process, most bankrupt enterprises have negative values (Lukowicz 1991).

Reprivatization

Privatization has been difficult in Poland for many reasons. One of the major sources of difficulties remains

the unresolved issue of property rights. Ownership claims that predate the communist era have not been resolved. Parliament, the government, and the president have all attempted to redress past wrongs, but political fragmentation has prevented resolution of this important issue. Reprivatization of land, residences, and business continues to be a major obstacle to establishing a viable market economy.

Land

After World War II, the communist land reform decree confiscated estates over 50 hectares of arable land. In 1948 when smaller properties still were under the control of property owners, the Minister of Agriculture issued a letter to redefine what was to be considered as farmable or arable land. The inclusion of roads, swamps, ditches, and ponds increased the arable hectares of many small estates, and the owners of these properties suddenly became enemies of the people. They were physically removed, and their estates were nationalized.

After 1989, owners of estates confiscated in the nationalization of property by the Communists formed the Polish Landowners Society. The society's membership grew to 3,000 by 1993. The Communists nationalized 1.7 million hectares of land and apportioned that land to the peasants. The peasants, who had worked the land for 40 years, have

strongly resisted repatriation efforts. The Sejm has been unable to resolve the land issue.

Residences

The effort to return houses to their original owners also has proved to be an insoluble problem. Many of the largest residences were used as centers for social services such as outpatient clinics, homes for the elderly and handicapped, or taken over by the PGR's, the large state-owned farms. If the residence is still in use as a social service facility, it is politically unpalatable to relocate these services because of the lack of other suitable locations.

Other legislative acts after World War II also deprived Poles of valid ownership claims. Apartment owners, along with other municipal site owners, had property confiscated. The communist state treasury seized the property purportedly to facilitate the reconstruction of Poland after World War II. Seizures, especially in Warsaw, were common. The city appropriated most apartment buildings and placed new tenants in the buildings, evicting the owners. The former owners were required to apply for the rights of perpetual usufruct, but the various local authorities never approved the applications. In this manner property owners lost the rights to their property. Conflicts among various interests have created a political stalemate, and parliament has been unable to pass a law on reprivatization acceptable to the

many political interests affected by changes in ownership. The government's inability to provide legal protection for private property ownership of land and real estate delayed privatization efforts and created a significant impediment to the valuation of SOEs.⁶⁵

Nationalization of Business

The Act on Nationalization of 3 January 1945 allowed the takeover of any industrial facility employing at least 50 workers. In practice, the Communist party confiscated everything deemed valuable irrespective of size (Hofman and Marek 1994). The Ministry of Urban Planning and Construction has annulled the 1945 decisions. Logically, provincial and local leaders who controlled these illegally seized properties should have been compelled to return these properties to the original owners. They were not. The Sejm could not agree on legislation to prevent the local governments from selling properties they controlled, and most have been sold to meet local budget needs (Styczek 1993c). The legality of the sales remains questionable, but it is unlikely that the splintered Sejm will act to enforce the return of property to private claimants.

⁶⁵Zenon Surala, head of the Department of Agriculture's Division of Revindications, only approves the return of property that is in the same condition as on the day of nationalization, a difficult requirement to meet since more than four decades have elapsed (Falczynski 1993).

The Reprivatization Law

In June 1991 the government and the president agreed on a draft reprivatization act. The government was not prepared to nullify the nationalization acts of the 1940s. The poor financial condition of Poland simply did not allow the state to fully compensate former owners. The Sejm ordered that, wherever possible, property will be returned. But, the law applies only in special cases where the impact will be limited because the property is dormant or capital investment has been minimal and the property is easily separated from the municipal, local, or cooperative holdings. Due to the complexity of the problem and a lack of state funds, claimants will be compensated with bonds which they can use to purchase shares in the newly privatized enterprises.⁶⁶ If a person has a legitimate claim to a specific firm being privatized, then he/she will be given priority in purchasing shares (Billewicz 1991).

In October 1993, the Council of Ministers passed a resolution to address the reprivatization issue. The ministry set aside special reserves in the state treasury in the form of physical property and shares in privatized companies to resolve ownership claims when the president and parliament finally agree on a solution (Hofman and Marek

⁶⁶The government and the president decided to separate the issue of state farms from the reprivatization act. The privatization of state farms would be resolved in a separate act.

1994). However, the inability of the Polish government to reach consensus with respect to property claims has delayed privatization and created significant valuation problems for accountants. Adoption of Western accounting standards where ownership claims are unresolved remains problematic.

Summary

Poland's leaders viewed privatization as being central to Poland's economic transformation. By August 1993 Poland had privatized one-fourth of SOEs in the manufacturing sector and the private sector employed 47% of the national work force, accounting for 25% of GDP. Although progress has been made, legal protection for property rights remains embryonic. The progress that has been made can be attributed in part to Western pressure. A meeting was held in spring 1993. Representatives of the Polish government, Polish banks, foreign aid organizations of the twenty-four advanced industrial countries, and members of the Polish private sector met to draft a plan to support small and medium-size businesses. The report defined the obstacles that limit the development of small businesses in Poland. Inflation, the budget deficit, an inadequate transportation network, and communications constitute macroeconomic hurdles, but social attitudes such as suspicion of private companies, negative attitudes toward business people, the non-tax-paying gray market, and unfair competition also continue to be obstacles. The report further identified the

scarcity of local capital, limited influx of foreign investment, reluctance of Polish banks to extend loans, inadequacy of business assistance networks, high cost of consultancy services, difficulties in adjusting to world standards, high costs of foreign market access, high customs duties on imports of equipment and raw materials, and illegal imports as major obstacles for the private sector.

Recommendations for improvements included: (1) issuance of a government document regarding its private sector policy; (2) new legislation on small business and reform of the civil law; (3) incentives for investment such as tax preferences, especially for investments that create jobs in areas of high unemployment and/or are related to the use of new technologies; (4) government coordination of consulting services, with efforts directed at providing affordable consultancy services for businesses either through subsidies or education and training; (5) creation of an Enterprise Council directly responsible to the prime minister; and (6) funding of a research institute that would collect and analyze information on small businesses (Styczek 1993a).

Privatization remains susceptible to changes in the political environment and the need to balance the state budget. Difficulties arise because of the financial distress of most of the SOEs undergoing privatization, the non-market relationship between workers and the enterprise,

the lack of capital, and the inadequacy of the previous accounting system.

Privatization entails more than simply disseminating property to private owners; it requires acceptance of individualistic social values that legitimate the private property rights paradigm in Western societies. It entails a fundamental change in social values and attitudes so that the populace accepts a new social system that relies on markets and property rights to resolve conflicts.

Accounting plays an important role as a facilitator in the transition. Privatization of SOEs is the core of the transition process, and development and acceptance of new accounting standards and methods is central to that process. The United Nations Commission on Transnational Corporations identified the difficulties encountered during privatization and concluded that the preponderance of problems are accounting related (United Nations 1992).

The following chapter examines accounting's role in the privatization process of three former SOEs. Valuation and transferability of ownership, which are central to the discussion of privatization, and the difficulties encountered when a new accounting system is imposed on an old one, are examined.

CHAPTER 4

ACCOUNTING--FACILITATION OF THE TRANSFORMATION

Western accounting standards are based on the assumption that investors and creditors seek to provide capital to those corporations that can employ economic resources most profitably. Financial statements provide the key measures of the efficiency and effectiveness with which the resources entrusted to an autonomous managerial class are used. Accounting is presumed to have a fundamental role in facilitating the efficient allocation of resources in a market economy (Paton and Littleton 1940).

None of the above conditions existed in Poland prior to privatization. The Central Planning Agency directed allocation of resources to state-owned enterprises (SOEs) to ensure full employment. No independent creditor or managerial class existed; banks, owned by the state, made short-term loans as directed by the planning agency. Subsidies from the state budget financed long-term investment, the size of the work force in an industry often determining the investment subsidy. Workers were expected to provide additional capital beyond the investment subsidy by accepting very low wages for the common good. Poland, like other Soviet Bloc countries, was constrained in its

allocation of national communal resources. Economic priorities were set in Moscow, not at home.

Western accounting evolved in very different circumstances. Initially, creditors created demands for financial reporting. Accountants responded to that demand by adopting a balance sheet focus and conventions, such as conservatism, to ensure that assets were not overstated. As capital markets evolved and ownership became separated from control, financial reporting became a critical factor for shareholders to monitor managerial performance. The focus of financial reporting shifted from the balance sheet to the income statement as income determination became more important than asset valuation.⁶⁷

I posit that I should see only moderate changes in financial reporting during the transition period due to the overriding need to maintain the appearance of solvency in a nation with limited sources of capital. The primary objective of the new Polish accounting system is to maintain a fine balance between culturally imported Western accounting standards required by Western sources of

⁶⁷See Carey (1969), Benston (1969), and Previts and Merino (1997) for different historical interpretations. Articulation between the balance sheet and the income statement requires accountants to focus on one statement; the other statement becomes a depository for residual values.

financing and actual socioeconomic conditions found in Poland during the transition.⁶⁸

Polish accountants faced a far more formidable task than their Western counterparts as they did not have the luxury of slowly developing an accounting system. Polish accountants had to simultaneously discard a massive system of state financing, state control, and a labor orientation. Accounting changes had to be made in the context of the political and economic transformation, balancing the domestic needs with International Monetary Fund (IMF) and World Bank requirements.

Not unexpectedly, Polish accountants encountered significant problems. The legal business framework that exists in market economies was non-existent in Poland. Therefore, accountants were called upon to facilitate the transformation process by adopting Western accounting practices into a system that did not offer protection to private ownership interests. The Poles had very little experience with Western accounting practices and Western corporate law (Gutner 1990). Westerners viewed accounting reform as central to successful Polish democratization. Cyrus Vance, head of a special task force to Poland, advised the newly elected premier, Tadeusz Mazowiecki, to establish as quickly as possible a comprehensive accounting system for

⁶⁸See Mandelbaum (1977) on the effects of cultural importation.

an open market economy (Cheney 1990). Jaruga (1993, 124)

states:

the return to the market economy, which involved starting from a situation where state ownership is dominant, and where there is no real market environment, creates very complicated conditions for legislative activities, among them the creation of new accounting regulations.

The remainder of this chapter is divided into the following sections: First, I discuss the theory and the reality of the communist-era system. Second, I examine three companies (Krosno, Prochnik, and Tonsil) that provide case evidence of the valuation process, focusing on the product lines, work force, and market potential of these companies. Third, I discuss the conditions present at the commencement of privatization and the pressures placed on Poland to adapt to a Western accounting orientation. Fourth, I discuss the Główny Urząd Statystyczny (GUS) statements which were used as the basis for valuation of SOEs being privatized. I then examine the valuation process to demonstrate how accounting techniques helped to create capital where market valuations did not exist. I conclude with an overall assessment of the three privatized firms by examining operations subsequent to privatization and a discussion of the role accounting played in facilitating privatization.

The Communist Accounting System

In order to understand the Polish accounting system and grasp the intensity of the changes that occurred, it is necessary to understand the theory and the reality of the past system. This perspective aids in understanding the direction, the complexity, and the magnitude of the changes that had to be made.

The Theory of the Past System

Oskar Lange (1936) wrote an article titled "On the Economic Theory of Socialism" as a rebuttal to von Mises's statement that economic accounting was not possible under socialism.⁶⁹ Lippincott (1938) stated that von Mises argued that the rational allocation of resources is impossible in a socialist society because the factors of production are not privately owned. Lange (1936) suggested that von Mises only provided a challenge for socialists that needed to be met by the organization of the centrally planned system according to scientific mathematical models.

In a subsequent article, Lange (1970) intimated that market economies relied upon accounting data that were

⁶⁹Benjamin Lippincott (1938) interprets Professor von Mises's views on socialism. Lippincott (1938, 11) states that "Professor von Mises . . . has argued that a rational allocation of resources is impossible in a socialist state on the ground that public ownership of the instruments of production does away with a market for capital goods . . . that where there is no market for capital goods, there can be no prices for them; and without prices, which indicate the relative importance of the factors of production . . . economic accounting is out of the question."

subjective and open to manipulation to facilitate allocation of societal resources. He argued that a centrally planned economy would rely upon objective mathematical derivations to allocate resources. He believed that input/output analysis would enable central planners to achieve socially efficient use of economic resources. Accounting, he concluded, would be superseded by mathematics.

Berry (1982, 186) suggests that the basic feature of socialist accounting was "the congruence of its structure with related elements of the Marxist-Leninist philosophy of dialectical materialism." Furthermore, accounting had to be congruent with Marxist economic policy. It must serve as the basis for the determination of the financial-economic model and must differentiate nonmaterial labor from material labor in accordance with the labor theory of value.⁷⁰

The Reality of the Past System

The accounting system served both macro- and micro-economic purposes. All countries under Soviet Union influence had similar accounting systems. The standardization of accounting practices was necessary to enable trade within the Soviet bloc, which was conducted on the ruble-control transfer system. Central planners determined socially desirable levels of output for each

⁷⁰Marx's labor theory of value placed importance only on labor used to produce physical products. Work in service industries was considered nonmaterial labor and was valued much lower than physical labor.

product; they then channelled resources to produce those goods and services, and prices were set according to political objectives and not market forces. Full employment, provision of basic needs such as food and housing, and maintaining a strong military capability were the major objectives. The actual cost of production became irrelevant. If goods and services were deemed essential, the Central Planning Agency subsidized their production irrespective of input costs. The results were an ever-increasing number of value-decreasing enterprises (i.e., bread priced at less than the production costs of grain) that could not be sustained. There were no incentives for efficient production in heavily subsidized industries, which meant that fewer resources were allocated to other goods and services with lower levels of subsidies.

Berry (1982) suggested that all Soviet bloc accounting could be categorized as scorekeeping rather than problem solving. The economic system and the entire accounting system were based on a philosophy of full employment. Unable to sustain itself and its goal, the system failed in 1980. Severe shortages reduced industrial output considerably, and the Polish economy was in a state of emergency (Berry and Jaruga 1985). The response to the failure was the establishment of a responsibility-oriented accounting system, and comprehensive reforms of the economy began. The plan called for new enterprise arrangements

based on the principles of self-finance, self-dependence, and self-management. In theory, the plan exuded hope for an improved economy; in actuality, the reforms did little to enhance the effectiveness of enterprise operations as subsidies continued.

There are several important reasons for the plan's failure. First, enterprises were required to recognize the basic relationship between costs and prices and to cover at least their operating costs; yet there were no bankruptcy laws to cover inefficient enterprises. Enterprises experiencing financial troubles received government assistance to continue production. Consequently, managers had little incentive to operate efficiently. Second, while enterprises theoretically could set their own outputs, prices, and resource requirements, they operated within the narrow constraints set by the central planning authorities. Management decisions could still be overridden by the central planners in Warsaw, who needed to satisfy demands from Moscow. Third, the principle of self-management was inoperative. Workers' councils could nullify all management decisions, but workers' power also was limited because the Polish United Workers' Party (PUWP) controlled all distributable funds and set workers' pay scales and bonuses.

The accounting system directly reflected the decisions of the central planners. If the central planners decided to produce a specific quantity of goods at a set price, those

goods were produced. Budgeted costs were set at levels to justify production. Any variance between budgeted cost and actual cost would be charged to the Central Planning Agency. The residual values in the accounting system of an enterprise reflected neither economic effectiveness nor efficiency, only the central planning decisions on fixed prices, costs, and levels of production. Since costs were not absorbed at the operating level, the macro, economic well being, was divorced from the micro, performance of the firm (Berry and Jaruga 1985).

Other attempts followed in the 1980s to "fix" the system. Changes were made to the accounting system in an attempt to simulate a market system in a centrally-planned economy (Berry and Jaruga 1985). Polish accounting rhetoric began to reflect Western principles, but the lack of private ownership and the lack of work incentives created a dysfunctional accounting system that had no problem-solving capability. The constraints of a centrally-planned economy (CPE) could not elicit accounting information that was responsive to reducing shortages, inflation, or inefficiencies. The accounting system could not be expected to provide relevant data as long as input data (costs) and output data (sales) did not reflect actual costs of inputs as the market value of outputs. The absence of a market mechanism made efforts to adopt Western accounting standards as a cure for economic malaise.

**The State-Owned Enterprises--
Krosno, Prochnik, and Tonsil**

Poland had neither a stock market nor a governmental securities commission when the first state-owned enterprises (SOEs) were privatized in 1990. The establishment of the Warsaw Stock Exchange and the Polish Securities Commission occurred four months after the public sale of shares in 1991. The prospectus that each enterprise prepared was also done without the benefit of a decree or a law. The decree mandating certain disclosures for all prospectuses was promulgated on 29 July 1991. Although there is a basic conformity with the form of presentation (corporate statutes at the end of the prospectus) and conformity in content (corporate statutes that are similar in content), there is diversity in types of financial information provided and diversity between the financial data in the prospectuses prepared retrospectively and the data filed prospectively with the Central Statistical Office (GUS) during the communist period.

Product Lines

At the onset of the democratization process, all three enterprises had products that were exportable. The enterprises had an established Western market for their goods and had not been reliant on the Council for Mutual Economic Assistance (COMECON) or the markets in the Soviet Union. Therefore, they did not face the chaos that

accompanied the dissolution of the ruble-transfer system. An analysis of the export activity of the enterprises in table 5 indicates that the companies' export markets were

TABLE 5
EXPORTS AS A PERCENTAGE
OF OVERALL PRODUCTION

	1990	1993
KROSNO	46%	53.8%
PROCHNIK	69%	50%
TONSIL	28%	29.3%

Source: Financial reports and prospectuses.

not transitory. Results from 1993 show that exports, as a percentage of overall production, increased for Krosno and Tonsil, but declined for Prochnik. However, Prochnik's export sales were strong relative to other firms in its industrial sector.

Krosno

Krosno was established in 1923 as a private Polish company. During World War II, the factory was destroyed and later rebuilt in 1944. When the war ended the factory was nationalized in June 1949. Krosno merged with another glass factory, Jaslo, which was established in 1927 and also nationalized after World War II. In 1970 another production facility was brought on line and incorporated into the

merged enterprise. At the time of privatization, Krosno consisted of seven separate production facilities.

Krosno manufactured products in four distinct classes: hand-cut leaded crystal items, standard household glassware, industrial glass, and fiberglass products. Statistics for the first six months of 1990 indicated that 54% of Krosno's production was for domestic markets, with the remainder sold on foreign markets. At the time of privatization all the categories of glass products except for hand-cut leaded crystal products were heavily reliant on a strong domestic market. The emergence of a recession at the onset of the Balcerowicz Program significantly reduced the demand for Polish products on the domestic market, and the collapse of the wholesale network greatly impacted Krosno's ability to sell its products. The export markets mainstay was leaded crystal products, with buyers in Germany, the United States, Australia, France, and the United Kingdom. Other export markets, including COMECON countries and Yugoslavia, experienced a demand barrier that reduced exports.

Prochnik

Prochnik began operations in 1945. The Lodz enterprise was established to clothe the military. After the war Prochnik began to expand its offerings by manufacturing women's, men's, and children's clothing. During the late 1950s export activities commenced, at first to the Soviet Union and later to Western markets that included West

Germany, France, the United Kingdom, and the United States.

As Prochnik began to expand its exports, it also began an internal expansion program to increase production facilities to service the new markets. During the 1960s and 1970s, Prochnik added production facilities in Lodz, Rawa Mazowiecka, Uniejowa, Poddebice, and Janikowo, as well as a new main headquarters in Lodz.

In 1987 Prochnik's management embarked on a program of modernization that was prompted by increased competition on the export market. The modernization included analyzing production capabilities and investing in new technology, which resulted in new equipment for some of the factories and closure of the Janikowo facility in 1990 and the consolidation of two facilities in Lodz.

At the commencement of the privatization process, 69% of Prochnik's sales were in the export market. A portion of the sales was based on labor contracts that were negotiated with Western clothing manufacturers. Materials and designs were shipped to Prochnik, and the company, in turn, assembled the clothing for the manufacturers.

The transition begun in 1989 changed the conditions for Prochnik's export sales. Prior to 1989 most of Prochnik's export sales had been handled through the trading company Confexim. When the currency laws changed in 1989, Prochnik began to look at the possibility of direct contact with its Western customers in an effort to increase profitability.

By 30 June 1990, 31% of Prochnik's export sales were handled directly without the assistance of any trading company.

Prochnik's main products in 1990 included five product lines: men's winter coats, men's summer coats, jackets, women's coats, and women's suits. The most successful product line was men's summer coats, at 54% of all domestic and foreign sales combined.

Tonsil

Tonsil, employing only 30 workers, was established in Inowroclaw during World War II to produce public address systems. The company became an SOE in 1951 and continued to add other electronic items to its product lines.

Technological improvements occurred in the 1970s when Tonsil purchased production equipment for speakers from Pioneer, a Japanese company, and German technology for headphones and microphones. With the new technology, quality improvements occurred; Tonsil expanded its product line to include boxed speaker sets, loudspeakers, microphones, telephone components, and headphones; and a large Western foreign market developed. In 1977 Tonsil opened its second plant in Leszno.

The political turmoil of the early 1980s decreased the demand for Tonsil's products. During martial law, from 1981 to 1983, Tonsil lost its foreign markets because of punitive measures imposed on Polish exports by Western governments, but, after 1983, Tonsil's trade activities with Western

Europe and West Germany resumed and by 30 June 1990, 27% of Tonsil's sales were export-related and predominantly in Western markets. Exports to COMECON were marginal.

Work Force

The law on privatization required that employees agree to privatize. Twenty percent of the stock of each of the enterprises was set aside for employee purchases at a 50% reduction from the public price.

The objective of the communist system had been full employment. Once the transition commenced, profitability became critical. As the enterprises struggled with the tough economic conditions without government subsidies, a reduction in the work force became the short-term solution to increase profits and productivity.

At Krosno the employees had agreed to privatization because Wieslaw Panter, the president of the enterprise, had promised increased wages. In March 1991, only two months after public shares were sold, the economic effects of the transition negatively impacted Krosno. Panter announced the redundancy of almost 25% of the work force, a 10% decrease in wages, and a reduction in Krosno's social obligations. He discontinued the financing of vacations, summer camps, cultural events, and employee meals (Trepkowska 1991).

An overall decrease in employment occurred (see table 6) for all three SOEs. Tonsil, too, substantially reduced

its work force. Most of the redundancies occurred immediately after privatization and prior to year-end 1992.

TABLE 6
CHANGES IN TOTAL EMPLOYMENT

	1990	1993	% Decrease
KROSNO	6,372	4,611	28%
PROCHNIK	2,479	2,136	14%
TONSIL	3,209	1,901	41%

Source: Financial reports and prospectuses.

Prochnik reduced its work force the least. By 1993 the company pledged increases in employee wages in excess of the inflation rate, realizing the need of a well-trained work force for future growth. At the same time, management envisioned further decreases in employment numbers because of expectations for increased profitability.⁷¹

Market Potential

Poland's location in Europe provides it with valuable opportunity for growth. With a population of 38 million and an educated work force, there is great potential in the domestic market. Poland's large shared border with the countries of the former Soviet Union give Poland easy access to other large consumer markets.

⁷¹See Prochnik's 1993 financial report for a discussion regarding management's perspective on future needs.

At the beginning of the transformation, Krosno, Prochnik, and Tonsil served both a domestic market as well as foreign markets. All had products that were marketable in Western markets, and none had been burdened with efforts to sustain dysfunctional Eastern markets. But, after privatization, all three companies continued to face significant export barriers as well as internal structural conditions that limited profitability. Western offers of assistance did not include an immediate reduction in tariffs on Polish products.

All SOEs were reliant on the banking system for short-term financing. If the banks reduced or withdrew the level of financing or increased the interest rates, Krosno, Tonsil, and Prochnik would have had difficulty maintaining their levels of production. The banks proceeded cautiously, limiting increased injections of capital. All three companies faced capital shortages that limited potential growth.

Rising energy costs and the uncertainty of natural gas and oil supplies from the Soviet Union created another barrier to success, especially for Krosno, which was heavily reliant on energy in the production process. Krosno could not switch to alternative energy sources without a large capital investment.

Krosno's management cited the difficulty in obtaining new technology as an important obstacle to future

development. Krosno's fiberglass products were based on obsolete English technology purchased more than ten years earlier. Without an investment in new technology, Krosno's management warned that it would have to cease production because of deteriorating market conditions for its fiberglass products. When adequate funding did not materialize in 1989, the fiberglass division did not remain competitive, and the value of its production decreased from 17% to 13% of total production by early 1990.

In the 1991 financial reports, both Krosno's and Prochnik's management cited difficulties during the transition, but they did not attribute the difficulty to the transition from a SOE to a publicly traded company, but rather to external factors. The formidable task of dealing with inflation, recession, and foreign currency fluctuations limited each firm's ability to reduce costs and to develop a new distribution network to handle domestic sales.

Neither the managements nor their Western advisors anticipated the magnitude of difficulties that the macroeconomic changes would cause. Krosno's president, Wieslaw Panter, reported that gross profit on exports was 50% at the beginning of 1990.⁷² By October 1990, because

⁷²Gross profit was calculated as sales minus cost of sales, but these accounts should not be equated with the same account names that are used in Western accounting. During this period, sales sometimes included the turnover tax and at other times did not, while various enterprise costs, unrelated to the sold products, were added to the cost of sales.

of inflation, specifically large increases in energy prices, and no change in the foreign currency rate, gross profit on exports for Krosno was only 7%. Furthermore, on some products, the cost was greater than the sales price, but management maintained that the sales had to be made in order to retain Krosno's export markets (Trepkowska 1991).

At the onset of the democratization process, Poland's domestic wholesale network collapsed. Domestic sales were further threatened by an increase in foreign products in the marketplace and lost market share when Polish customers preferred foreign products over domestic ones simply because they were not made in Poland. Faced with decreasing sales on the domestic market, all three SOEs were faced with the task of developing their own distribution network.

Prior to 1989 most SOEs had little trouble selling their products on the domestic market irrespective of quality. When the democratization process began, lowered tariffs brought in a large array of competing imported products of similar or better quality. The initial shock to the SOEs was difficulty in selling products in the home market. For example, Tonsil held a monopoly on the domestic market for stereo speakers. A good strong demand on the home market for consumer products and a 25% tariff on the import of speakers ensured a strong domestic market. With democratization, however, the tariff was reduced to 14% in 1990, enough to bring in an influx of a variety of competing

Western products that diluted Tonsil's strong position on the home market.

Although Poland represented a large market potential, the immediate benefits were limited due to a confusing and unprecedented political and economic environment that slowed development of an effective market structure. The dissolution of communist institutions and the inability of new market institutions to replace them contributed to the chaos, obscuring the true potential of many SOEs.

Adopting a Western Accounting Orientation

As the privatization process began in 1990, the financial reporting of the privatized companies adapted a Western orientation; suppliers of capital, not labor, became the focal point. Each privatized company offered for public trading prepared a prospectus to acquaint investors with the history, the current activities, and the future prospects of the company. The need to raise capital was paramount. The Polish government's desire was to present companies in a manner that would attract both Polish and foreign investors. Once privatized, an enterprise could apply for special assistance in the form of low-interest long-term loans from the various international organizations and foreign governments participating in the transformation. In most cases, the large sums of money committed to the transition by these external organizations stipulated private ownership as a prerequisite for loan consideration. They also

required periodic financial reports to measure and assess managerial performance.

Western financial and legal advisors assisted the Ministry of Ownership Changes in the privatization of the first five publicly traded companies. Of the three SOEs examined in this study, two employed audit firms from the EC. Prochnik, atypical of most privatized Polish firms during this period, employed Polish auditors. While differences exist among the prospectuses, they are similar in their attempt to present accounting information according to International Accounting Standards Committee (IASC) standards and the Fourth Directive of the European Community (EC) promulgated on July 25, 1978.⁷³

The Fourth Directive

The Fourth Directive requires that financial statements present a "true and fair" view of a company's assets, liabilities, financial position, and profit or loss. The

⁷³The EC directive that relates to financial reporting is the Fourth Council Directive of July 25, 1978. But each EC country must enact legislation before a directive becomes binding in each country. To encourage compliance with each EC directive and uniformity among nations, all legislation is translated into all languages of the EC member countries. Alexander and Archer (1991) suggest that the appearance of compliance may be misleading because semantic differences and nuances of languages may result in different applications of a provision of the directive in various EC countries. The legislative infrastructure of a country and differing cultural orientations of each individual EC country also prevent uniform adoption and treatment of certain provisions.

interpretation of what is "true" and what is "fair" may vary considerably, given the differing historical accounting traditions of member countries. Compliance with the "true and fair" position requires that financial statements can deviate from the Fourth Directive in order to present a true and fair position of the company, but any deviation must be explained and disclosed in the notes. What constitutes an exception may differ among the member states. Each member state defined the exceptions when adopting the Fourth Directive into its own legislative framework, thus increasing the degree of latitude of accounting differences regarding the meaning of the concept. Since Poland had yet to promulgate standards, considerable latitude existed in complying with the directive.⁷⁴

The overriding position of a true and fair view comes from the influence of United Kingdom GAAP and the 1948 United Kingdom Companies Act where it was first introduced. The concept has never been defined.⁷⁵ The "true and fair" concept has been a controversial issue in the harmonization process of the EC because the failure to define the concept

⁷⁴In 1990, at the time of the first privatization, Poland did not have any promulgated standards. The central planning system had collapsed, but vestiges of the system remained. The Ministry of Finance incorporated the old system to assess taxes on the SOEs. The legislature approved the first principles of accounting in 1991, but the law on accounting was not promulgated until September 1994.

⁷⁵See Ernst & Young (1990, 10-12) for a discussion regarding the introduction of the "true and fair" concept.

of "true and fair" makes implementation difficult, especially in countries that do not have a common law tradition or a GAAP-based accounting system. In countries that have detailed commercial codes, accounting is part of a codified legal structure. The accounting issue in commercial code countries is not whether something is generally accepted but whether it is in accordance with the law.

International Accounting Standards Committee Standards

The IASC also influences European accounting; these standards have authority similar to EC Directives. The existence of two competing standard-setting bodies that may have conflicting accounting rules creates further obstacles to implementation of the "true and fair" view.

When developing new accounting principles during the transition that were based on market-oriented Western systems, Poland's Ministry of Finance attempted to draw upon the German model, the Napoleonic Code, and Anglo-Saxon standards to comply with both the EC Fourth Directive and IASC standards (Arthur Andersen & Co. 1991).

Poland faced a formidable task in meeting the demands for implementation of a Western accounting system. First, the Sejm had not resolved the issue of how to redistribute communal assets to the populace. Poland still had no bankruptcy law nor laws protecting private property rights.

These Polish accountants were being asked to devise an accounting system based on private property rights and an ownership orientation prior to promulgation of an adequate legal framework.

Second, Poland was asked to adopt an undefined principle--"true and fair view"--that relied heavily on the professional judgment of the accountant. As Hopwood (1990) points out, the British who were the chief proponents of the true and fair view promoted an ambiguous standard because it served their claims to professional status.

Financial reporting designed to provide information to investors and creditors had no role in a centrally planned economy. GUS required a standardized format for enterprise reporting to aid the central government authorities in allocating resources. As the transformation process began, the GUS documents provided the sole data source with respect to each enterprise's resources and obligations. The GUS numbers, which provided the source material for the subsequent valuation of SOEs, have no relationship to the market values of an SOEs assets.⁷⁶ Asset values, incorporated into the accounting records, reflected fixed prices based on the political objectives of the PUWP and implemented through the Central Planning Agency.

⁷⁶See Jaruga and Szychta (1996) for a discussion on the evolution of accounting in Poland since World War II. They examine the changes in the system of mandatory charts of accounts.

When the first enterprises were privatized and shares publicly offered in 1990, there were no Polish guidelines for financial reporting. Decisions on the principles of accounting, external financial reporting formats, and disclosure rules had not been made. Jaruga (1992) contends that financial accounting had to be developed quickly to meet Western demands. Geopolitical and economic considerations encouraged an EC approach with the adoption of the Fourth Council Directive of 25 July 1978 as a model for accounting change. The result was the Decree of the Ministry of Finance on the Principles of Accounting in 1991, which established a new chart of accounts. The accounting principles and the chart of accounts formed the basis of accounting regulation from 1991-1994. In 1994 the principles were revised, and a new accounting law was promulgated, but the new changes introduced by the new law are outside the scope of this study.

GUS Statements

SOEs prepared yearly GUS statements. Changes in the statements occurred occasionally to facilitate the needs of the central planners. The statements were administrative mechanisms employed to regulate the implementation of plans at the enterprise level and to reconcile the state budget with enterprise wealth (Jaruga 1988). GUS statements for 1987-1989 were examined for the following analysis.

It would be unreasonable to criticize Polish firms for failing to meet the stringent demands of Western accounting when issuing their prospectuses. The analysis below highlights why Western standards had to be modified to meet the unique conditions found in transition economies. Thus, while Poland had to adopt IASC standards and the EC Fourth Directive to gain access to capital, those standards were not rigorously applied.

At the Third Investors' Forum in Warsaw in 1992, a panel discussion addressed the problem of accounting difficulties encountered during privatization. Michael Baker, managing partner for Price Waterhouse in Warsaw, warned investors that, although account names seemed similar, accounting practices made the substance of these accounts questionable. He cautioned investors that "neither a simple translation of the accounts nor an audit of the accounts according to local principles is appropriate."⁷⁷ Baker explained that interest penalties at the rate of 60% per year were charged on overdue receivables. SOEs recognized the charge as revenue, and accounts receivables continued to carry the overdue account, inflated by the accruing penalties. There was never any recognition that an overdue receivable, including penalties, would not be paid.

⁷⁷See Michael Baker's discussion on the transformation of the former GUS accounts to accounts based on Western accounting principles in "What Have We Learned?" Privatization Update (1992, 2-4).

The central issue for Polish accounting was how to manage privatization without creating the appearance that all SOEs were bankrupt from the start, the certain result if firms adopted conservative Western standards promulgated for developed market economies. The need for external financing required importation of IAS and EC standards. The presence of the World Bank, the International Monetary Fund (IMF), and future expectations of capital investments from Western countries limited the choices.

Polish accountants faced a daunting task of transforming GUS scorekeeping records, based on artificial prices set by the central planner into a reasonable facsimile of Western financial reports. The solution, appropriate to the circumstances, was parallel to that adopted by accountants at the turn of the century when faced with grossly overvalued assets in the newly formed trusts.⁷⁸ Financial capitalists, who promoted the trusts, issued "watered stock," i.e., stock where little or no consideration had been received by the corporation, to effect the mergers. Proprietary theorists recognized that asset values and capital were overstated, but to have required immediate write-off of overvalued assets would have resulted in financial reports that suggested most trusts

⁷⁸See Merino (1993) for complete discussion of changes used by proprietary theorists.

were insolvent.⁷⁹ They resolved this dilemma by first recording goodwill based on expected future earning power and, second, by amortizing the goodwill over time in order to limit distribution of dividends and make good the initial recorded equity capital. Thus, accountants did more than report; they used accounting data to create a new reality that became fact with the passage of time.

Polish accountants, a century later, find themselves faced with a similar task. The GUS scorekeeping data never were intended to reflect market data. They were based on artificial prices set by the Central Planning Agency to meet political objectives. Privatization does not result in new capital to an SOE; the funds go to the state treasury. Polish accountants faced the seemingly impossible task of slowly adapting Western standards in an uncertain economic environment without creating the perception that all SOEs were in a state of bankruptcy. It would have been foolish not to recognize all assets, including intangible assets, that accounting does not usually recognize, particularly the future earning power of the enterprise in the newly emerging domestic market. Consequently, assets had to be created to vindicate the equity capital recorded by the state. This study examines the procedures adopted to achieve that end.

⁷⁹As Hatfield (1909) points out, the more technically correct accounting would have been to use a contra-equity account to show that the corporation had received no consideration for stock issued.

To highlight these tradeoffs, I analyze the financial data provided by three SOEs, Krosno, Prochnik, and Tonsil, for the transition period. Since these companies were considered among the most economically viable of Poland's SOEs, they provide an excellent case study of the internal factors that required Polish financial reporting to deviate from Western standards.

My analysis begins with an overview of the data and classifications found in GUS statements based on the 1976 uniform chart of accounts.⁸⁰ I use the Krosno 1988 GUS statements to provide an in-depth analysis of the accounting issues that had to be addressed and examine the changes that occurred in 1989 in anticipation of privatization. Then I examine the deviations from the GUS statements found in the prospectuses. An analysis of the valuation process follows to demonstrate how accountants created capital. The final section assesses the adequacy of financial reporting and disclosure subsequent to privatization, using 1993 as the focal point. One objective is to underscore the fact that even Poland's best SOEs had no capital base at the time of privatization.

I have conducted a comparative analysis of the three companies to highlight the degree to which assets remained

⁸⁰Jaruga and Szychta (1996) present all the official charts of accounts that were promulgated after World War II. The 1976 chart of accounts was not replaced until 1991, but changes were made throughout the 15-year period to reflect the changing priorities of the PUWP.

overvalued (in excess of market prices) and the accounting techniques used to create capital. I conclude with a discussion of the degree to which the Polish financial reports can be used to make financial decisions.

The 1988 GUS Reports

Each company was required to prepare financial reports at the end of the year. It must be remembered that these reports were never intended for use by external users for investment decisions. The Central Planning Office and GUS used the statements to determine the level of subsidies and control SOE activities.

GUS reports were based on the 1976 Chart of Accounts and changed very little over time. Changes that occurred in 1989 foreshadowed privatization. In 1988, the GUS report began a metamorphosis from a purely communist form to a form more representative of a Western accounting system. However, as the following analysis shows, the modifications should be regarded as symbolic since no substantive changes occurred.

The following analysis discusses the various categories of the 1988 GUS statement, highlighting the difficulties of interpreting these values. The discussion begins with the asset side of the statement and then proceeds to the liability side. Then I highlight the differences between the 1988 and the 1989 statement to show the effects of

anticipated privatization and pressure from Western sources to comply with market concepts.

In the absence of private property rights, the accounting equation was "Assets = Liabilities" because there was no ownership interest in Poland.⁸¹ During the communist period, political objectives precluded the unbundling of property rights. This analysis begins with the assets and then proceeds to the liabilities.

Assets

The categories used in the statement are found in table 7. For 1988 there are six major groups of assets. Group A assets, defined as investing activities, represent values for assets in construction. There are line items for investments, receivables on investments, and machinery, tools, and materials used for investments, and receivables on investments.

Group B assets identified as plant, property, equipment (PPE), and retired fixed assets also include intangibles. While depreciation was charged, assets with little use value remained on the books. There is no indication that obsolete assets were removed from the books. An addendum to the liabilities presents line items for accumulated depreciation which reveals sums to be as large in value or greater than

⁸¹Because the objectives were political, there was no need to measure efficiency through an income statement. The income statement accounts reflected the peculiarities of the communist system.

PPE. Although accumulated depreciation appears on the liability side, it is not added to total liabilities, and fixed assets are valued at net amounts. The large amounts for accumulated depreciation relative to the net amount for fixed assets, however, raises valuation questions regarding the age and condition of the assets. Since the following analysis shows that, although there was a line-item for retired fixed assets, none of the enterprises examined in this study used the classification.

Group B (plant, property, equipment, and retired fixed assets) also appears to be overvalued with the inclusion of intangibles. The value of these intangibles is questionable since the inclusion of goodwill, trademarks, and trade names did not occur until after the adaptation of Western accounting standards. Therefore, consideration of intangibles in Poland prior to privatization is controversial.

Most current assets are found under Group C (inventories and receivables). The statement distinguishes among raw materials, goods for resale, finished goods, and work in process. All inventory was based on artificial costs for inputs charged to the SOE by the Central Planning Agency. Finished goods were listed at the SOEs sale price, also an artificial price based on political objectives of the central planners. Inventory at sales price would be overstated from a Western perspective. In addition, there

TABLE 7

MAIN COMPONENTS OF ASSETS REQUIRED
FOR GUS STATEMENTS

1987 and 1988	1989
Group A - Investing activities (Dzialalnosc inwestycyjna)	I - Fixed assets and investments (Majatek trwaly i inwestycje)
Group B - Plant, property and equipment, and retired fixed assets (Srodki trwale i wydzielone)	II - Retired fixed assets (Srodki Wydzielone)
Group C - Inventories and receivables (Zapasy i naleznosci fakturowe) I. Raw materials (Zapasy ogolem) II. Goods for resale (Towary handlowe) III. Finished goods and work in process (Produkty gotowe i nie zakonczone) IV. Prepaids (Rozliczenia miedzyokresowe czynne) V. Accounts receivable (Naleznosci z tytulu dostaw, robot i uslug) VI. Assets decreasing the reserve fund (Aktywa pomniejszajace fundusz wlasny w obrocie)	III - Inventories, current assets, and prepaids (Zapasy rzeczowych srodkow obrotowych i rozliczenia miedzyokresowe kosztow)
Group D - Other assets utilized in operations (Pozostale aktywa dzialalnosci eksploatacyjnej) I. Cash (Srodki pieniezne) II. Other receivables (Rozrachunki) III. Other (Inne)	IV - Cash and receivables (Srodki pieniezne i rozrachunki)
Group E - Financial results and distribution (Wynik finansowy i jego podzial)	V - Distribution of financial activity from inventories and accounts receivable (Srodki pieniezne, zapasy i rozrachunki dzialalnosci finansowo wyodrebnionej)
Group F - Distribution of financial activity (Dzialalnosc finansowo wyodrebniona)	VI - Financial results and distribution (Wynik finansowy i jego podzial)
Rounding error (Sumy z zaokraglenia)	VII - Rounding error (Sumy z zaokraglenia)
Total assets (Razem aktywa)	VIII - Total assets (Razem Aktywa)

Source: GUS schedules 1987-1989.

were no write-offs for obsolescence of inventory. The Group C classification is very broad. Included in this group of assets as subaccounts are prepaids, interperiod purchases, and the cost of remodelling.

Accounts receivable is the largest value that appears in Group C (inventories and receivables). Communist policies and the 1976 chart of accounts allow receivables to remain on the books for many years when uncertainty about collectibility existed. Overvaluation is exacerbated by the addition of interest on past due accounts at rates in some periods exceeding 60% per year. Consequently, the expectation of accounts receivable, or for that matter, any receivable on the books, is gross overstatement.

The last major subclassification in Group C (inventories and receivables), assets decreasing the reserve fund, is disputable. My analysis suggests that the values in this subclassification refer to long-term investments in other companies and are not current assets in a Western sense. The reported values of affiliated entities may be viewed as problematic and not necessarily equal to past costs invested or to any adjustments similar to United States equity method accounting.

Group D assets include current assets: cash, receivables, and other. This category of assets is one of the most problematic. The cash account in the GUS statements required large adjustment during the

privatization process. Cash amounts should be objectively and easily determined. The fact that the auditors at privatization found the cash problematic calls into question the reliability of all values reported in the communist financial reports. What the Communists recorded as cash and what Western accountants view as cash are clearly different. There are two plausible explanations. First, there may have been difficulties accounting for transfer rubles. A difference between the official exchange rate and the ruble-transfer rate may have affected the cash balance. Second, without well-defined property rights, funds allocated for employee needs may have received diverse treatment. Future research should address this cash enigma.

Group D assets (other assets utilized in operations) include other receivables. Of particular interest is the state budget receivable. The expected value of such a receivable would be its future collectibility; however, collectibility was dependent on successful privatization. If privatization had required significant write-offs of assets, then the state budget would go into deficit. If assets were written down to market value, then the state receivable would, in all probability, be uncollectible. Given the choice, accountants chose to allow continued overvaluation of assets.

Finally, the last subclassification included in Group D assets (other assets utilized in operations) is other

assets. This other-asset category consists of doubtful receivables with a high probability of uncollectibility. This is not a contra-asset account, but a classification significantly different from those found in Western reports. The classification consists of receivables with a high probability of uncollectibility; the debtor had been declared insolvent. It is highly unlikely that collectibility would be possible since it usually took a decade or more for these troubled accounts to be reclassified.

Group E assets (financial results and distribution) are an anomaly from a Western perspective. They are part of the inherent structure of the central planning system. This classification with its counterpart on the liability side (table 8, Group E liabilities defined as financial results and subsidies) were used in the communist system to determine what the SOE owed to the state budget and the level of subsidies due from the state to the SOE.

The final classification, Group F assets (distribution of financial activity), seems to have been peculiar to the GUS system. Companies handled accounts in this section very differently during privatization, and most of the assets in this category seem to disappear after privatization.⁸²

⁸²Group E and Group F assets and liabilities, designed to implement political objectives and control enterprise activities, were inherent to the communist system and cannot be equated to an accounting system designed for a market-based economy. Furthermore, research on the use of these

Liabilities

Although the asset side of the statement resembles in form some categories that would normally be associated with Western accounting, the liability side is atypical, based on the communist system's reliance on fund accounting (see table 8). Prior to 1989, the liability side of the balance sheet contained certain accounts that reflected not past obligations but future expectations of the Central Planning Agency. The system required a return to the state, a system of transfer pricing, and is reflected in funds that are not directly attached to workers' interest. These funds eventually were collapsed into state ownership rights and became part of the state's claim.

The first group of liabilities are related to investment activities and include an investment fund, and a trade payable and bank credit specifically related to Group A assets (investment activities). Although Group B liabilities (basic funds) appear to be merely related to Group B assets (PPE and retired assets), line items include a statutory fund for PPE, other funds related to central planning, and other payables identified with PPE and intangibles.

Group C liabilities (enterprise fund for working capital, current liabilities, obligations financing

accounts generated no additional explanations. Attempts at addressing this issue with users did not provide clarification as well.

TABLE 8
MAIN COMPONENTS OF LIABILITIES REQUIRED
FOR GUS STATEMENTS

1987 AND 1988	1989
Group A - Investment activities (Dzialalnosc inwestycyjna)	I - Basic funds, credits and loans for investments (Fundusze podstawowe oraz kredyty i pozyczki na inwestycje)
Group B - Basic funds (Fundusze podstawowe)	II - Funds for retired assets (Fundusze srodki wydzielone)
Group C - Enterprise fund for working capital, current liabilities, obligations financing inventories and receivables (Fundusze wlasne w obr. kredyty obr. i zobowiazania finansujace zapasy i naleznosci) I. Enterprise fund for working capital (Fundusz wlasny w obrocie) II. Current liabilities (Kredyty obrotowe) III. Obligations financing inventories and receivables (Zobowiazania finansujace zapasy i naleznosci)	III - Current credits and loans, also obligations (Kredyty i pozyczki obrotowe oraz zobowiazania)
Group D - Other liabilities from enterprise activities (Pozostale pasywa dzialalnosci eksploatacyjnej) I. Accounts (Rozrachunki) II. Reserves and income from future periods (Rezerwy i dochody przyszlych okresow)	IV - Reserves and income from future periods (Rezerwy i dochody przyszlych okresow)
Group E - Financial results and subsidies (Wynik finansowy i dotacje)	V - Other funds and obligations of financial activity distribution (Pozostale fundusze i zobowiazania dzialalnosci finansowo wyodrebnionej)
Group F - Distribution of financial activity (Dzialalnosc finansowa wyodrebniona) I. Employee fund (Fundusze dla zalogi) II. Development funds (Fundusz rozwojowe) III. Remaining special funds (Pozostale fundusze specjalne) IV. Accounts of financial activity distribution (Rozrachunki dzialalnosci finansowo wyodrebnionej) V. Credits and loans for financial activity distribution (Kredyty i pozyczki na dzialalnosc finansowo wyodrebniona)	VI - Financial results and its distribution (Wynik finansowy i jego podzial)
Rounding error (Sumy z zaokraglenia)	VII - Rounding error (Sumy z zaokraglenia)
Total liabilities (Razem pasywa)	VIII - Total liabilities (Razem pasywa)

Source: GUS schedules 1987-1989.

inventories and receivables) are devoted to operations and include current liabilities, both trade and bank payables, and an enterprise fund for working capital, a fund reflecting statutory obligations to the state. The third subclassification under Group C liabilities isolates those liabilities that directly relate to inventories and receivables. This classification represents an unusual situation where there is a payable on a receivable. Again there seems to be a situation where there are offsetting accounts. The state records both a receivable and a payable due to the complex relationships between SOEs and the state. In Western accounting it is very unusual for a source of financing to have a position on the asset side of the balance sheet, whereas in the communist system, the state gives subsidies to the SOE and receives part of the profit back. The accounts simply reflect the complex interrelationships between the state and enterprises. In the absence of an ownership interest, market prices, and a market exchange mechanism, the liability side of the balance sheet simply reflects the communal interest in the SOE.

From a Western perspective, Group C (enterprise fund for working capital, current liabilities, obligations for financing inventories and receivables) contains some obligations that one would expect to see recorded as liabilities. These include liabilities related to the purchase of inventories, obligations to be paid to the state

budget, wages payable, and insurance payable. Other liabilities seem to be particular artifacts of the communist system that allowed central planners to offer "hard data" to justify their decisions.

Group D contains other liabilities, reserves for shortages and damages, and unearned revenue. Unearned revenue can be either a correction to sales or recorded for other undisclosed reasons. While Group E (financial results and subsidies) represents the obligations to the state for its interests, Group F (distribution of financial activity) represents obligations to employees for their interest and to the enterprise itself for continued development. Obligations to employees are in the form of a social fund, housing fund, a general employee fund, and an inflation fund. Funds for development are subdivided into three enterprise funds: a development fund, a technical fund, and a fund to cover obligations. While subclassification III (remaining special funds) of Group F liabilities (distribution of financial activity) includes a reserve fund, the last two sections of this group represent classifications of distributions for activities unique to a communist system.

Changes in Reporting for 1989

The changes that appeared in 1989 were directed at simulating a Western reporting system, and, in form, the balance sheet was forced to reconcile Western concepts with

central planning idiosyncracies. A statement of results that had been attached to the 1988 form was removed from the balance sheet and expanded to resemble a Western income statement.

Assets

The greatest change in the presentation was the segregation of assets into noncurrent and current. There appeared to be an increased Western orientation as if in anticipation of privatization. And an examination of the dates of Krosno's (May 1990), Prochnik's (April 1990) and Tonsil's (March 1990) GUS statements indicate that the companies were already in the process of privatizing. The first two major 1989 asset classifications, I and II, represent noncurrent assets. Group A (investing activities) and Group B (plant, property, and equipment, and retired fixed assets) assets from 1988 were collapsed into I assets (fixed assets and investments). The receivables that had been included in the old classifications were excluded to make the new classification consistent with European standards. The I assets (fixed assets and investments) represented noncurrent assets, recorded and listed first on the balance sheet in accordance with Western European standards. In Europe, unlike the United States where assets are listed in order of liquidity, assets are listed in terms of expected life. Retired assets were no longer part of PPE, but classified separately as II assets.

The classification labeled III (inventories, current assets, and prepaids) and IV (cash and receivables) combined reflect current assets, segregated between inventory and quick assets. The III classification assembles the 1988 assets in Group C (inventories and receivables) almost in its entirety except for receivables that had been removed to the quick assets, classification IV for 1989.

The V classification (distribution of financial activity from cash, inventory, etc.) and VI (financial results and distribution), idiosyncratic to a communist system and identical to 1988 Group E (financial results and distribution) and 1988 Group F (distribution of financial activity) assets in prior years, continued to be segregated from the rest of the accounts and would require significant adjustment for privatization.

Liabilities

Although the asset arrangement received some minor adjustments, not unexpectedly, the liability side required significantly greater changes in anticipation of privatization. Ownership interests had to be reflected in the accounts. The 1989 GUS statement was the beginning of the shift to reflect the state's, creditors', and workers' ownership interests. The state's interest was reflected in I (basic funds, credits and loans, etc.). Two new funds appeared, the founding fund and the enterprise fund, which replaced the statutory fund on fixed assets from 1988 Group

B (basic funds) and the statutory fund on current assets from 1988 Group C (enterprise fund for working capital, current liabilities, etc).

The II liability classification became a new separate category that correlated with the II classification in assets. On the asset side it was listed as retired assets and on the liability side, as a fund for retired assets. None of the examined enterprises used this classification.

In III classification (current credits and loans) there clearly was an attempt to categorize all payables together. Classifications in 1988 as well as 1989 did not distinguish between current and long-term liabilities. Research indicated that the dichotomy did not exist because there rarely were any long-term liabilities in the centrally-planned system. Therefore, the obligations in III are short term and include those liabilities from 1988 Group C and Group D, except those listed under reserves and income from future periods. Those line items became IV (reserves and income from future periods) in 1989.

A major change in the liabilities occurred with 1988 Group F liabilities (distribution of financial activity). The employee fund and all the development funds disappeared. In their place appeared an enterprise fund and an obligation that made up the totality of V (other funds and obligations of financial activity). The enterprise fund in V represented employee claims on the enterprise, whereas the

enterprise fund in I (basic funds) represented the state's claims on the enterprise. The idiosyncratic 1988 Group E (financial results and subsidies) classifications became VI (financial results and its distribution) in 1989.

Finally, the form of the 1989 GUS statement was altered, indicating the inclusion of modifications intended to resemble Western statements, particularly the promulgated EC format. There was (1) a consolidation of all noncurrent asset accounts into I (fixed assets and investments), (2) an inclusive III (inventories, current assets and prepaids) set aside for all inventories, (3) an incorporation of most quick assets under one heading, IV (cash and receivables), (4) a clarification of certain funds and the elimination of others, and (5) an effort to list all "western-type" liabilities together. These changes appear to have been cosmetic and did not incorporate any real substantive changes on the asset side. All the objections and difficulties raised in the preceding discussion of the 1988 GUS statements still remained. Most of the accounts that were present in 1988 remained; they were just reclassified. However, substantive changes did occur on the liability side, with a move to extract the state's interest in the enterprise from the employees' and other creditors' and a separation of overall state interest from individual enterprise interests.

Valuation and Privatization

The most fundamental issue in any privatization is valuation. According to the Centre for Co-operation with European Economies, an organization established in 1990 by the Organization for Economic Co-operation and Development (OECD) to assist economies in the transition,

Valuation is a prerequisite for successful privatisation. Privatisation agencies need to determine fair value to support their negotiations with investors and to justify the sales price after reaching an agreement. Investors will use valuations to determine a risk adjusted price which will allow them to achieve the desired level of profitability. (O.E.C.D. 1992, back cover)

The United Nations Commission on Transnational Corporations acknowledges accounting's key role in privatization with its 1993 publication Accounting, Valuation and Privatization.

The lack of good accounting information presents a barrier to privatization since valuation of the firm is difficult. As the language of business, the task of accounting is to provide useful information for potential investors and the government (United Nations 1992). The following is an examination of the accounting evidence regarding Poland's privatization of three of its first publicly traded companies.

In 1989 GUS classificatory changes were made to anticipate privatization. Special attention was directed at aggregating and the classification of legitimate ownership claims that would occur after privatization. The classification was primarily set up to identify ownership

claims and to comply with EC and international standards because of the need to obtain foreign capital.

The privatization process began in 1990 at the same time the SOEs were reporting their 1989 financial information to GUS. Accountants engaged to assist in the privatization used the 1989 GUS financial reports to aid in the valuation process. Therefore, I have used the 1989 GUS statements to examine the classificatory changes that were needed to present the statements according to Western standards and to identify any substantive modifications that occurred. The following section examines the techniques accountants used to sustain the going-concern concept, followed by an assessment of subsequent operations and financial reporting.

Changes in the Prospectus from 1989 GUS

Although the valuation and classification of accounts reflect different patterns among the three enterprises, the difference represents only an overall 1.1% decrease in assets over the three-year period 1987-1989.⁸³ There are three variations: no changes from GUS (Krosno), overall increases (Prochnik), and overall decreases (Tonsil). Further examination indicates that only a slight reclassification and valuation of the accounts occurred.

⁸³See appendix A for an anatomization of the accounts according to the GUS classifications in comparison to the prospectus classifications.

Assets

The presentation of the accounting information for each SOE varied, but there were a number of important similarities.⁸⁴ First, there was little variation from GUS regarding the noncurrent assets. Agreement on the value of PPE (srodki trwale) as a fixed asset was consistent with the GUS statement. All three SOEs used the GUS value for PPE from 1989 classification I (fixed assets and investments) for the prospectus. Tonsil presented a classification for tangible assets on the face of the balance sheet and provided a schedule disaggregating the tangible assets which included a line item for PPE.

Second, the subclassification from I (fixed assets and investments) labeled "investment in other companies," was transferred in its entirety into the prospectus and afforded a separate classification. Treatment of intangibles, a line item in I (fixed assets and investments), however, received varied treatment. Prochnik did not report any intangibles for either GUS or the prospectus, but Tonsil and Krosno did. It appears that Tonsil collapsed the intangibles into investments in progress. Krosno provided a separate classification on the balance sheet for intangibles.

Current assets are more problematic and provide evidence of classificatory as well as substantive changes.

⁸⁴Appendix B provides a list of the classifications used by each SOE in the prospectus for the balance sheet.

First, except for some classification differences, acceptance of the valuation from III (inventories, current assets, and prepaids) is uniform. While Krosno and Tonsil list inventories on the balance sheet with the inclusion of prepaids, Prochnik disaggregates prepaids from inventory and provides a special classification.

Second, IV (cash and receivables) and V (distribution of financial activity from cash, inventories, and receivables) exhibit changes in substance as well as form. The largest digression and substantive change from GUS is in the cash account. Tonsil manifests a substantially different total from GUS in the prospectus. This total represents an 89% decrease in cash as it appears in the GUS statement. Since there is no schedule for cash, the reason for the difference is not known. Krosno, on the other hand, provides a schedule for cash based on the GUS classifications, and an account called "account for special funds" from asset classification V (distribution of financial activities from cash, inventories, and accounts receivables) is added to the cash accounts from IV (cash and receivables). Although Prochnik provides a schedule for cash, the schedule does not use the GUS accounts but subdivides the cash into domestic currency and foreign currency; when employing Krosno's classification methodology, Prochnik presents no deviation from GUS.

Some modifications are made to receivables. Krosno incorporates a line item in classification V (distribution of financial activities from cash, inventories, and accounts receivables) into the receivables listed in IV (cash and receivables), a change in form only. The other two SOEs increase receivables, Tonsil (19%) and Prochnik (6%).

The symbolic changes that GUS made to the assets in 1989 prevailed and were accepted at book value during privatization, with few changes. However, the irregularity with the valuation of cash supports the proposition that the historic cost model based on historic political prices for communist SOEs was unable to provide an adequate base line for investment decisions.

Liabilities and Equities

Privatization required the identification of ownership claims. An attempt at disaggregating workers' and state interest occurred with the 1989 GUS statements, but at the time of privatization a number of special funds remained, including employee and special purpose funds.

Treatment of liabilities in the prospectus was similar for all three SOEs. While the assets had been highlighted with multiple line items, the liabilities appeared in two line items on the balance sheet, short-term and long-term liabilities. Schedules for short-term liabilities indicated that there was some consistency in the valuation of the liabilities. Bank credits that were found in 1989

liability classification III (current credits and loans) appeared in their entirety for all SOEs. Valuation of other short-term liabilities received diverse treatment.

While Krosno defined accounts payable by adding the accounts payable and uninvoiced supplies, line items in III (current credits and loans) together, Tonsil used the entirety of the line item for accounts payable only. Prochnik used neither technique and presented an increased valuation for accounts payable.

Krosno's treatment of the liabilities was the most transparent and included accounts from III (current credits and loans), IV (reserves and income from future periods), and V (other funds and obligations). While Tonsil tended to collapse all short-term liabilities into an "other" category, Prochnik highlighted the individual obligations to the workers and to the state.

Prochnik and Krosno collapsed accounts in I (basic funds) and presented them as long-term liabilities in the prospectus. Tonsil did the same but downgraded the liability by 35%. Two other accounts in I, founding fund and enterprise fund, formed the basis of the state's equity interest in the enterprise. The valuation of the liabilities and assets directly affected the value of the state's interest. Since there had been no change in Krosno's assets or liabilities from GUS to the prospectus, the value of the two funds remained unchanged in the

prospectus; however, Prochnik and Tonsil recorded some changes, and decreases occurred in the two funds, 55% and 16% respectively.

The most substantive change that occurred was Tonsil's immediate incorporation of Western standards with respect to liabilities. The accountants evaluated the liabilities and then created a series of new accounts. Special reserves were set up for liabilities and charges, a social fund, an enterprise fund, product warranties, and the catchall term, other liabilities. These changes appeared in the additional schedules that were provided with the prospectus.

In 1989 Polish accountants prepared for the adoption of Western standards by making classificatory changes to the 1988 GUS statement. At the inception of privatization, the 1989 GUS statements represented the financial reporting practices of the SOEs. When independent accountants prepared prospectuses in anticipation of privatization for the SOEs, they incorporated the changes of the 1989 GUS, made their own individual classificatory changes, and attempted to make some substantive changes. An examination of total assets in appendix A indicates that adjustments were made to the historic cost model that developed during the communist system of administered prices, but the differences are minor and reflect in most cases the classificatory changes that were needed for the adoption of

a Western format for the presentation of financial information for privatization.

Creation of Capital

Accountants had the difficult task of presenting financial statements based on an historic cost model that did not reflect market conditions. The GUS financial reports represented numbers that had no theoretical justification, and accountants constrained by Western accounting principles and standards were obliged to restate the communist statements in a manner that would seem to provide relevant and reliable information for investors and protect the going-concern assumption. Because the SOEs represented a tremendous future market potential domestically, the simplest solution would have been to book the future potential as goodwill and amortize the amount over a 40-year period. European accounting standards precluded Polish accountants from adopting the goodwill solution. The allowable solution was a general price-level adjustment to fixed assets and the retention of the overstated amounts in receivables and inventories.

At the time of the privatization of Krosno, Prochnik, and Tonsil, the capital stock was set a 110,000 million zlotys, 30,000 million zlotys, and 60,000 million zlotys, respectively. It is not evident how or why the capital stock was set at these levels, but an examination of the totals for the primary balance sheet accounts, particularly

the column labeled "Enterprise Fund" in the restated prospectus (table 9), provides some insight on the range of possible values that could have been used to establish the capital stock account.

Krosno's enterprise fund account equaled 208,681 million zlotys on 30 June 1990 which included a 126,610 million zlotys reevaluation of fixed assets. Without the reevaluation, it would have been impossible to establish a 110,000 million zlotys capital account. Table 10 disaggregates the information in table 9 and examines the primary balance sheet accounts without the general price-level change that occurred in 1990. The revaluation of the fixed assets provided accountants with the ability to establish a capital stock account. The same is true for Tonsil. The enterprise fund account of 77,901 million zlotys included a 41,947 million zlotys increase from the reevaluation of fixed assets. An examination of Prochnik's enterprise funds accounts indicates that Prochnik was the only one of the three enterprises able to cover the established capital stock account without the inclusion of the revaluation of the fixed assets.

Krosno's capital account of 110,000 million zlotys included 2,200,000 shares at 65,000 (approx. \$6) zlotys par. The initial offering was only for 50% of the shares. Twenty percent of the shares were set aside for the employees at a preferential price of 32,500 (approx. \$3) zlotys, one-half

TABLE 9

BALANCE SHEET ACCOUNTS FROM THE INDIVIDUAL
PROSPECTUSES
(in million zlotys)

	Assets	Liabilities	Enterprise Funds	Net revaluation amount of Fixed Assets
KROSNO				
1987	13,065	3,992	9,073	
1988	22,317	6,161	15,436	4,716
1989	63,458	22,476	38,681	
as of 6/30/90	278,327	64,643	208,681	126,610
PROCHNIK				
1987	4,021	1,064	2,957	
1988	7,540	2,844	4,696	747
1989	41,894	15,536	26,358	
as of 9/30/90	100,783	32,478	68,305	23,183
TONSIL				
1987	4,744	2,323	2,421	
1988	9,170	4,255	4,915	1,153
1989	53,554	38,907	14,647	
as of 6/30/90	183,804	105,903	77,901	41,947

Source: Individual prospectuses.

TABLE 10

COMPARISON OF 1990 AMOUNTS ESTABLISHED FOR EQUITY
VS. VALUE OF CAPITAL STOCK ISSUED AND THE
REVALUATION OF FIXED ASSETS
(in million zlotys)

	Equity/ Enterprise Funds before Revaluation	Value of Capital Stock Issued	Net Revaluation amount of Fixed Assets
KROSNO	82,071	110,000	126,610
PROCHNIK	45,122	30,000	23,183
TONSIL	35,954	60,000	41,947

Source: Individual prospectuses.

the public offer price.⁸⁵ The state treasury retained 30% of the shares with the intent of selling those shares at auction to a strategic investor. But on 1 January 1994 the state treasury had still not found a strategic foreign investor and held 35% of the shares, 30% of the original shares withheld from public sale and 5% of the employee shares which had never been sold.

As with Krosno, the government, too, set aside 30% of the 1,500,000 shares of Tonsil for a future strategic investor. The government offered 750,000 shares at a par value of 40,000 (approx. \$4) zlotys and a sale price of 80,000 (approx. \$8) zlotys to the public. Retained for

⁸⁵Article 24 of the Act on Privatization specifically enumerates the rights of workers in the privatization process and sets aside 20% of the shares for them on a preferential basis.

employees was the statutory 20% in addition to 450,000 shares for the strategic investor; however, similar to Krosno, the state treasury held more than the planned amount of shares on 1 January 1994. Rather than the 30% that the government had originally planned to retain for a strategic investor, 47% of the shares were held by the state treasury, indicating that, similar to Krosno's employees, the workers at Tonsil had reservations about the investment in their own enterprise.

Unlike Krosno and Tonsil, all of Prochnik's capital stock, 1,500,000 shares at a nominal value of 20,000 zlotys per share and a sale price of 50,000 zlotys (approx. \$5) each, was sold. Employees purchased the statutory 20% at one-half the public offer price.

Accountants knew that little reliance could be placed on the historic GUS statements, but they realized that it was politically dangerous to assign zero values to assets that the government needed to sell to meet its obligations with the World Bank and IMF. With the large potential of the Polish market and tight capital rationing, accountants also knew that these companies were among the best of Polish SOEs. The creation of value through general price-level adjustments and the retention of overstated assets resolved the dilemma for accountants forced to use arbitrary GUS numbers within the confines of the narrow rules and regulations of Western accounting practices.

**Assessment of KROSNO, PROCHNIK, and TONSIL
Subsequent to Privatization**

In early 1990, as the privatization process commenced, work began in the Ministry of Finance on developing accounting regulations that would meet the requirements of the EC Fourth Directive and IASC standards. The result was the promulgation of accounting principles which became applicable in 1991 for all enterprises.⁸⁶ Although the long-term objective was compatibility with EC standards, Polish accountants adopted an incremental approach. The 1991 principles incorporated the Fourth Directive, but recognized the unique Polish conditions by including some items that would normally be considered ordinary activities as extraordinary and the retaining of workers's funds accumulated during the communist era. While Polish law required that workers' funds be held in trust, most SOEs used these assets as part of their working capital (Arthur Andersen & Co. 1991). Additionally, not until the 1995 reporting period when a law on accounting came into effect did Polish accounting address the issue of consolidations (EC Seventh Directive) and reporting for banks and insurance companies (EC Eighth Directive).

⁸⁶The decree excluded banks and insurance companies that had annual sales in excess of 2,500 million zlotys, approximately \$263,000 at the time the decree was enacted.

Reporting Practices

After Krosno, Prochnik, and Tonsil were privatized, the Decree on Accounting Principles governed the form of financial accounting requiring continued adaptation of GUS statements that began in 1989. However, the lack of justification for the original amounts recorded in GUS statements made the changes only symbolic.

The first-ever published Polish annual reports appeared for year end 31 December 1991 and included more than the 1991 calendar year. The 1991 annual reports represented the first formalized published information on the privatized companies and included financial information since privatization in 1990. Although the 1991 principles on accounting governed the substance and content of the accounting, no law regulated the form of the financial reports. The disclosure requirements stipulated the inclusion of a profit and loss statement, a balance sheet, and a management report.

Krzywda et al. (1994) examined the 1991 reporting and disclosure practices of eight of the nine enterprises privatized and offered for public sale.⁸⁷ They found great disparities in the financial reporting, making comparisons among enterprises difficult particularly for the Polish investor unfamiliar with Western accounting terminology.

⁸⁷Tonsil was not included in the Krzywda et al. (1990) analysis.

But that criticism could be extended to include all investors since missing information made it difficult to reconcile the original prospectuses with the subsequent report.

The financial reports for calendar year 1991 were published in the second quarter of 1992, more than 16 months after the publication in Rzeczpospolita of the original prospectuses. More than 21 months since the 30 June 1990 dated information in Krosno's and Tonsil's prospectuses and 18 months since the 30 September 1990 dated information from Prochnik before financial reports were published. Although all three 1991 financial statements stated that they were in accordance with the Decree on Accounting Principles, the difficulties in the transition from a command economy, a centrally controlled reporting system, to a market system were evident. Moreover, the quality, the quantity, and the readability of the reports varied dramatically. As the companies struggled to adapt to a market economy, they grappled with the cultural importation of Western accounting standards.

The most readable report came from Prochnik, the most voluminous, from Krosno, and the least informative, from Tonsil. Prochnik was the only company that provided continuous information. The prospectus covered the first nine months of 1990, and the 1991 balance sheet used the closing 30 September 1990 amounts as the opening balances

for the 1991 statement, with relatively few changes. Minor classifications and terminology changed from the prospectus, but these were easily reconciled with additional schedules to the financial statements. The company showed an additional increase in total assets of 228 million zlotys to the ending balance sheet for 30 September 1990 which included an increase in fixed assets, decrease in inventory, and an increase in receivables. The adjustments increased payables by 8 million zlotys and the capital stock account by the remainder, 220 million zlotys. Although Prochnik's report was continuous, it lacked comparability by time period since the last three months of 1990 were collapsed into 1991.

Krosno's 1991 financial report provided substantial information; however, the 1991 report included Krosno as a privatized company and included the last two and one-half months of 1990. The inclusion of 1991 as a 14 1/2 months reporting period makes comparisons with either past or future periods difficult. Additionally, the 1990 prospectus included only the first six months of 1990, leaving three and one-half months omitted from any report.

Financial liquidity became the initial concern of management. To reduce costs, large reductions in the labor force occurred at Krosno and Tonsil. Overstated domestic receivables compounded the liquidity problem for all three companies as these assets should have been written off.

Even accounts with traditionally good customers were in arrears due to deteriorating economic conditions. Prochnik supplied uniforms to the police, army, and other governmental agencies, but the government's need to balance the budget to meet Western conditions reduced funding to these agencies, and they delayed paying their current obligations. Krosno and Tonsil supplied the Polish automotive industry with products, but by 1991 automotive enterprises were experiencing major liquidity problems themselves. They also were unable to pay their current obligations.

Managers at the three privatized firms had to decide whether to continue to sell products on credit or to discontinue the business relationships with many traditional customers. They lacked the analytical skills to make these decisions, and the uncertain economic environment simply compounded the difficulty of their task. To have written off bad debts or even to have made a realistic estimate of uncollectible accounts would have resulted in technical bankruptcy. Instead, management sought to maintain an aura of financial liquidity by allowing all receivables to remain on the books. At the end of 1991 the majority (96%) of Krosno's receivables were past due, with more than 24% over six months old, and the other companies were in a similar situation.

The 1992 financial reports of the three companies reflected the formidable task that the country had undertaken to transform itself from a CPE to a market-oriented system. Both Tonsil and Krosno reported losses after privatization. The end of 1992 signaled two years of loss for Tonsil. As measures of ameliorative action, the state treasury decided to delay payment of Tonsil's turnover tax and the Ministry of Ownership Changes became active in restructuring Tonsil's debt to Wielkopolski Bank Kredytowy (WBK) and reducing Tonsil's financial responsibility.

As in 1991, there were difficulties with Tonsil's financial report. Unique to Tonsil were difficulties with the formal presentation of information and disclosure of financial information. There were discrepancies with the income statement and with the form and substance of presentation for 1991 and 1992. And, perhaps as a holdover from the communist period, the calculation of total assets included the addition of the year-end loss, creating an obfuscated view for the investor as to the financial position of the company.

Newly established Polish accounting firms audited the 1992 financial reports for all three companies. In 1992 the new law on auditing came into effect and required compliance. The law on auditing requires the examiner to issue a true and fair view and to state any threats to the going-concern assumption. The law defines the meaning of

true and fair, but in a most circuitous way. A true view is granted if the accounting information is based on the accounting records and on the laws and principles of Polish accounting. A fair view is warranted only if the presentation of the financial results is given in accordance with a true view. Consequently, a fair view is predicated upon a true one, which is based on the underlying accounting records. Since the underlying data that came from GUS statements was problematic, true and fair appears to have little significance in the Polish context.

Both Prochnik and Tonsil received favorable reports as to the true and fair view. Because the taxing authorities had been unable to establish the criteria for year-end taxes within their new Western accounting practices, auditors issued qualified opinions subject to determination of tax liabilities. However, Krosno's Polish auditors were much more harsh. They issued an adverse opinion that listed numerous irregularities and offenses as a result of Krosno's divergence from principles of accounting and the new legislation. They cited irregularities with respect to valuation of inventories, including finished goods and fixed assets, verification of inventory amounts, identification of fixed assets, confirmation of receivable balances, and recognition of unearned revenue. They also noted that legal infractions encompassed activities related to the assumption of loans, depreciation and the sale of fixed assets related

to social and housing activities, the method of determining Krosno's tax liability, and the incorporation of an equity investment into the company's books before its privatization and transfer of ownership occurred. The auditors questioned the going-concern assumption due to Krosno's liquidity problems, concluding that without additional financing the company might be forced into liquidation.

The year 1992 was a year of crisis for all three companies. The euphoria of privatization had passed, and the tasks of restructuring, modernizing, and increasing production efficiency and sales with relatively no new sources of financing presented major hurdles for management. Maintaining financial liquidity proved to be the most difficult task. Prochnik's management sought to maintain a low debt level and to decrease its collection period for trade receivables. Prochnik was in the most favorable position, having reduced the average collection period in 1991 of 45 days to 29 days in 1992, but some questionable accounts remained on the books, including 12.5% of trade receivables that were more than 180 days in arrears. Krosno and Tonsil were not as fortunate: 41% of Krosno's trade receivables were over 180 days in arrears, while more than 50% of Tonsil's receivables were past due from companies either in bankruptcy or in the process of liquidation.⁸⁸

⁸⁸More accurate comparisons are not possible because of the lack of comparable data. Only Prochnik and Krosno provide a schedule for trade receivables.

Adoption of conservative accounting techniques, favored by the EC and IASC, not only would have been suicidal, it also may have been misleading. The government still owned substantial shares of Krosno and Tonsil and would not let the companies fail. Activities at Tonsil indicated that the government was still willing to subsidize enterprises that continued to have future potential. Conflicting interests resolved in favor of continuity notwithstanding accounting rules.

While the companies grappled with the management of current assets, a new accounting reporting problem emerged in 1992 as a result of solving the receivable problem: the effect on accounting numbers of debt/equity swaps. With the swaps came the possibility of an equity or a controlling interest in another company requiring equity or consolidation accounting, which the new 1991 accounting principles did not address. Moreover, there was a nascent move to invest in other companies as a means of securing better access to raw materials, products, or simply as an alternative investment. Although the three companies had numerous small investments in many companies that would not have required accounting treatment other than those addressed in the new accounting principles, four investments required an alternative to the cost method: Tonsil had a 20% or more interest in two companies; Krosno reported financial interest in a company on its balance sheet before the final

acquisition; and Prochnik had a 44% interest in a woolen mill. There was no evidence of equity accounting in any of the financial reports.

The basis for the 1993 financial reports and the auditors' investigations remained the same as in 1992; all three companies received a true and fair opinion from their auditors. By 1993 Tonsil and Krosno managed to emerge from their financial crisis, and Prochnik continued to increase its financial liquidity.

Fixed assets were revalued again in 1993 by Krosno and Prochnik, yet no schedules or entries indicated a revaluation for Tonsil. Both Prochnik and Krosno included a line item, revaluation reserve under capital, 6,333 million zlotys for Prochnik and 35,081 million zlotys for Krosno, while Tonsil included the line item but indicated a zero amount.

Collectibility and validity of receivables could be more readily assessed. Both Krosno and Prochnik sent out confirmations. Although neither Tonsil's management nor their auditors indicate whether confirmations were sent out, management does indicate that 1993 brought a reduction in average time outstanding for invoices from 109 days to 85. Krosno's receivable turnover was reduced from an average 68 days in 1992 to 53 days in 1993, and all communist-era receivables had been settled. Management attested to the fact that all the receivables that appeared in Krosno's

books were current receivables from the 1991-1993 period. Prochnik's receivable situation appeared to be the best, with only 13% of trade receivables more than 90 days past due.

What emerged in 1992 as a nascent problem with equity investments in other companies remained unresolved in 1993. Although the companies had begun to manage their current assets and increase financial liquidity, there were no guidelines on equity investments or on consolidations. The accounting treatment for these equity investments was unclear in all three companies. There were no accounting principles that governed combinations in Poland at this time. There was no indication or information regarding alternate accounting treatment for equity or consolidated companies. Krosno had spun off a unit, the Jaslo Glass Factory, and converted it into a limited liability company, wholly owned and controlled by Krosno. The company appeared as an investment on Krosno's balance sheet, but the accounting treatment for Jaslo was not disclosed.

According to Western accounting standards, financial liquidity was a problem in the post-privatization period. On the other hand, Western accounting was ill-equipped to value the government support and subsidies that continued during this period. The going-concern assumption could have been a problem had the government withdrawn its support. From a political standpoint, the Polish government was

unlikely to let the firms fail, particularly since the first firms privatized and publicly traded were touted as Poland's best.

Financial Ratios and Inflation Adjustments

An examination of the financial ratios and inflation adjusted sales in tables 11 and 12 support the preceding discussion that (1) financial liquidity was paramount at the onset, (2) increased costs and decreased sales impaired profits, and (3) adjusting to inflationary conditions reduced the relevance of the reported accounting numbers.

All the ratios in table 11 present a positive outlook for the three enterprises at the point of privatization; only after privatization does the outlook deteriorate. The combination of the effect of the changing economic system and the changing accounting priorities is reflected in the ratios.

The contracting profit margin indicates a decrease in efficiency in the adoption period.⁸⁹ Elimination of subsidies, increased costs, and competition jeopardized even the best of Poland's SOEs.

The financial reports indicate that overall effectiveness decreased, with the most dramatic downward change occurring at Krosno and Tonsil, the two enterprises

⁸⁹The calculation for profit margin does not incorporate the effect of interest and tax because of the difficulty of disaggregating total tax during the CPE.

TABLE 11
FINANCIAL RATIOS⁹⁰

Profit Margin

	1988	1990	1991	1992	1993
KROSNO	8.6%	20.1%	0.3%	0	1.3%
PROCHNIK	10.8%	23.0%	3.3%	8.0%	9.1%
TONSIL	7.5%	14.1%	- 8.3%	- 25.2%	2.1%

Asset Turnover

	1988	1990	1991	1992	1993
KROSNO	1.23	1.29	.78	.84	1.02
PROCHNIK	1.84	1.25	1.48	1.81	1.86
TONSIL	2.05	1.08	1.02	.65	1.06

Return on Assets

	1988	1990	1991	1992	1993
KROSNO	10.6%	25.9%	0.2%	0	1.3%
PROCHNIK	19.9%	28.8%	4.9%	14.5%	16.9%
TONSIL	15.4%	15.2%	-8.5%	-16.4%	2.2%

Working Capital Ratio

	1988	1990	1991	1992	1993
KROSNO	1.89	1.91	.99	1.00	0.94
PROCHNIK	1.91	2.06	1.90	2.33	2.50
TONSIL	1.67	1.22	0.94	0.79	1.20

Debt-to-Equity

	1988	1990	1991	1992	1993
KROSNO	.45	.33	.78	.80	.77
PROCHNIK	.61	.48	.44	.68	.74
TONSIL	.87	1.36	.94	1.32	1.96

⁹⁰Profit margin = Net income/Net sales; Asset turnover = Net sales/Average total assets; Return on assets = Profit margin X Asset turnover; Working capital ratio = Current liabilities/Current assets; Debt to equity = Total liabilities/ Total equity.

where the government unsuccessfully sought the help of a strategic Western investor. However, inflated assets due to general price-level adjustments makes it difficult to interpret asset turnover because of the measurement scale problem. In addition, comparing 1988 income may be misleading because excess costs have been absorbed by the Central Planning Agency and reported costs may not reflect actual costs.

Return on assets in the post-communist period presents a distressing view of the viability of Krosno and Tonsil. Only Prochnik seems to have adapted to the new economic environment. An examination of the working capital ratio supports this dismal conclusion. The ratio is far worse than indicated during the 1991-1993 period. Current assets incorporate overstated accounts receivables and inventories, while current liabilities are overstated due to prohibitive interest rates for long-term loans.

The debt-to-equity ratio indicates that all companies had to increase debt significantly. Most of the debt was in the form of current liabilities, reflecting short-term financing, and it financed long-term as well as short-term assets.

An inspection of table 12 confirms the difficulty of the transition as effectiveness decreased more than 52% for all three enterprises. Prochnik exhibits fairly positive

ratios in table 11, yet manifests a 57% decline in inflation-adjusted sales over the 1987-1993 period.

The examination of accounting information subsequent to privatization indicates that the watered stock created to address the issue of the future potential of the privatized enterprise will take many periods to realize. But some progress has been made in reducing overstated current assets, although the fixed-asset accounts continue to be questionable. Past price-level adjustments continue to distort the valuation of fixed assets.

A performance measurement that appeared in all three prospectuses--number of units sold by product line--disappeared in subsequent reports. This is unfortunate since quantity measurement of performance may be the most relevant disclosure in the current Polish environment. The number of units sold provides comparable information to counter the inadequacies of historic cost measurement in a hyper-inflationary economic environment.

Appropriateness of the Response to Privatization

The Poles had no choice but to comply with Western demands, but they had to do so with discretion. The "value" of Polish SOEs would not be reflected in existing accounting records since much of the value could be attributed to expected future earnings. Poland had a large domestic market and a highly educated work force, and it occupied

TABLE 12

INFLATION ADJUSTED SALES
(million zlotys)
1993=100

	1987	1988	1989	1990	1991	1992	1993
KROSNO	1,584,660	1,721,011	1,519,101	1,079,944	1,116,620	789,362	754,470
PROCHNIK	898,282	898,029	821,945	483,382	372,652	395,210	390,377
TONSIL	1,027,097	1,128,508	1,139,343	N/A	534,012	308,262	307,183

Source: Individual prospectuses and financial reports.

a central location for distribution on the European continent.⁹¹ Pent-up consumer demand, combined with significant infrastructure investment, provided tremendous future potential.

Accountants faced a formidable task in adapting Western standards, based on the private property rights paradigm, to the economic conditions in Poland. They had to do so prior to the establishment of a legal framework to protect private property rights and before an exchange-based economy was operative. First, accountants had to reclassify accounts to establish ownership interests. The claims of the workers and government had to be recognized. Since much of the value of an SOE would be its expected future earnings, the existing accounting data would not support these ownership claims.

In many respects, the situation in Poland resembled that in the United States at the turn of the century. The formation of large corporations, called trusts, had rendered

⁹¹ Demographic information on Poland can be found on the Internet (<http://www.odci.gov/cia/publications/95fact/pl.html>). There was a tremendous potential for growth. Opportunities existed in telecommunications. In 1991 the telephone system was severely underdeveloped. By 1994 the situation had improved, with 12.7 phones per 100 residents. The U.S. Department of Commerce views Poland as a big emerging market, referring to Poland as "one of the fastest growing significant economies in Europe (Poland BEMS Home Page, <http://www.statusa.gov/bems/bemspol/bemspol.html>)." Total imports have risen from \$8 billion in 1990 to \$19 billion in 1993.

accounting book values obsolete. Accountants responded to that challenge in an imaginative manner by capitalizing the trusts, based on their expected future earning power, and recording goodwill for the difference between expected future earning power and book value. Financial capitalists issued common stock as a "bonus"; the trusts received the cash inflow and the stock had no tangible asset base. Accountants devised a system to make the "watered stock" good by amortizing goodwill to income in subsequent years, which limited dividends and ensured reinvestment.⁹² Some trusts, burdened by watered stock based on overoptimistic estimates of future earnings, failed; but most survived. Over approximately a 20-year period, the fictitious (no consideration given) common stock had been made whole by the implementation of an accounting technique that forced reinvestment.

Polish accountants faced a similar scenario and looked for a feasible solution. Book values did not reflect the future earning potential of the SOEs, and the SOEs would receive no funds at the time of privatization.⁹³ The state

⁹²See Merino (1993) for discussion of how proprietary theorists resolved this dilemma. The problem of watered stock raised the wrath of those who believed accounting data should reflect the "facts." See Hatfield (1909) who wanted common stock to show a zero balance with goodwill recorded as a contra-equity account.

⁹³Benefits accruing to the SOEs undergoing privatization were an increased attractiveness to foreign investors. The government hoped that its macroeconomic policy would attract foreign investments that would provide

budget received the proceeds from the sales of the enterprises to workers and other citizens. Under the constraints of the EC Fourth Directive and IASC standards, accountants could not use the relatively straightforward procedure of estimating future earning power, recording goodwill, and valuing common stock issued on the basis of goodwill.⁹⁴

The accountants resolved the conflict between an historic cost accounting system that did not reflect the future earning potential and the need to establish ownership claims based on future earning potential by using inflation adjustments to create equity. Both the IASC standards and the EC Fourth Directive allow for the reevaluation of fixed assets in an inflationary economy. Using inflation accounting based on book values, accountants were able to create enterprise value that better reflected the future potential of the SOEs undergoing privatization.

the needed capital for future growth.

⁹⁴Western accounting barred the implementation of the simple solution. Recording goodwill as a surrogate for future earning power was not a plausible solution. The EC Fourth Directive requires the purchase of goodwill and amortization over five years. Even if accountants had been allowed to use the goodwill solution, the amortization period was too short.

CHAPTER 5

CONCLUSION

A growing number of researchers have recognized the powerful role that accounting plays in the social construction of reality. These researchers reject the depiction of accounting as a "mere" technical discipline as inadequate; they posit an interactive role for the discipline, arguing that, while it shapes economic reality, it also is shaped by the particular socioeconomic context in which it operates. The newly emerging democracies of Eastern Europe provide an excellent laboratory in which to test the interactive thesis. The radical and unprecedented changes required in transforming a centrally-planned economy (CPE) to a free market economy required radical changes in the communist-era accounting system.

The primary objective of this study was to provide greater insight into the role accounting played during the transition period in facilitating radical change. I examined the external influences that impacted Polish accounting and the adaptation of Western accounting standards to fit the Polish environment and analyzed the impact of imperatives designed to extricate a free market economy from a centrally-planned system.

Within the changing political and economic environment, I analyzed the financial records of three of Poland's earliest privatized companies to determine how the communist accounts were changed to meet the needs of the new economic milieu. The study highlighted how accounting methods were used to create capital so that Polish state-owned enterprises (SOEs) would appear to be viable and address the imposed requirements of the World Bank and the International Monetary Fund. Reliance on these international organizations and foreign governments, particularly the United States and the countries of the European Community (EC), committed Poland to the adoption of a neoclassical approach to its economic transition and recovery. Poland needed to raise capital for the economic transformation, but first it had to address the issue of its past foreign debt. New financing was contingent on two tasks: (1) the ability to negotiate a reduction in the old debt and (2) the ability to present an image of fiscal responsibility. The second task relied on the state-owned enterprises to provide the funds to balance the budget through privatization and in the form of taxes.

Accounting became instrumental to the task. Accountants were asked to determine values and extricate private property rights from a communal property system. Their task was complicated by changing priorities in the political and economic environment. The need for external

financing and future expectations with respect to economic integration with the European Union required importation of International Accounting Standards Committee (IASC) and EC standards.

Koslowski (1992) posited that privatization in Poland was extremely complex because of the lack of a fully functioning state. This study supports Koslowski's thesis. The economic transformation relied on the passage of laws and the establishment of market structures that were in many cases delayed and incomplete. A lack of consensus within parliament and between parliament and the president, as well as a court system unable to adjudicate in a noncommunist system, impeded privatization.

Comisso (1991) argued that resolution of property rights attached in the communal system had to be transformed into a public system before privatization could occur. While one might posit that decisions regarding the rights of ownership of SOEs needed resolution before privatization could occur, this has not been the case in Poland. Control over the nation's wealth remained in an undefined state structure, with indeterminate ownership rights. The inability to resolve the property-rights issue continues to be an obstacle to privatization and to acceptance of Western accounting standards.

The absence of an adequate legal framework did not deter Poles from using accounting as an instrument of

change. Despite the rhetoric on the difficulties associated with the process of transforming a former CPE into a market economy, a presumption existed that accounting could establish the "proper value" for an SOE and determine on an ongoing basis the profitability of SOEs.

Accounting was used to determine value with the original communist data providing the basis for privatization. Poland adopted the historic cost model as the basis despite its formidable limitations in a hyper-inflationary economy. Since the original "cost" of assets held by Polish SOEs reflected a myriad of central planning decisions, the underlying data had no market referent. However, the historic cost model was depicted as providing objective data that investors could rely on for investment decisions. Trust in the final number was a necessary condition for privatization to occur.

The analysis included an examination of financial statements prepared during the communist period. The purpose of these statements, filed with the Central Statistical Office (GUS), was for central planning use. The values in the statements never purported to represent market prices; prices had been set by central planners for scorekeeping purposes. A comparison of the prospective 1987-1989 GUS statements for the three SOEs (Krosno, Prochnik, Tonsil) to the retrospective revalued financial statements found in the prospectus of each SOE indicated

that not many adjustments were made. By using the values in the GUS statements as the basis for enterprise worth, accountants legitimized the GUS statements during the privatization process. Accounting legitimated GUS statements, making them appear credible.

Deteriorating economic conditions, particularly inflation, made the valuation of SOEs for privatization more difficult. The Communists addressed the issue of capital maintenance with general price level adjustments. These general price level decisions, based on central planning needs, required adjustments to fixed assets that reflected neither replacement nor current cost. Similar to the synthetic prices of the ruble transfer system, the adjustment was simply a metric. The adjustment inflated the net worth of assets, with little regard to either value in use or value in exchange.

During the period of analysis (1987-1993), there were four price level adjustments--two before and two after privatization. The price level adjustments after privatization attempted to incorporate a system of specific price level adjustments, but the two adjustments prior to privatization were general price level adjustments. The increases in fixed assets were based on central planning allocative criteria with no ceiling. When incorporated into the GUS statements, these adjustments represented large manipulated increases that merely reflected changes in the

measurement scale used. The oldest assets received the highest increase in cost with no consideration for use value. An examination of the GUS statements and the prospectuses reveals that accountants did not question the appropriateness of the adjusted GUS statements as the basis for fixed assets. Conventions, such as lower-of-cost or market, and write-offs of obsolete property, did not occur. In this manner accountants were able to create an economic reality for the enterprise that was different from either the exchange or use value of its asset base. The net result was financial statements that had no theoretical foundation, yet appeared to be a reasonable facsimile of Western financial reports.

Accountants' acceptance of general price level adjustments without questions enabled them to present values that represented the future potential of a SOE, not its past costs. Polish accountants had little choice. Adoption of conservative Western standards promulgated for developed market economies would have produced an impression that all SOEs should be liquidated. The first five enterprises that were privatized were considered Poland's best. If accountants had used conservative Western standards, even Poland's best would have been candidates for liquidation. The liquidation of all SOEs was not a feasible choice. Economic solutions to Poland's malaise were based on the government's ability to raise funds through the

privatization of SOEs and the taxation of viable firms. Environmental conditions required that accountants assume Polish SOEs could survive without subsidies. The Polish government and its Western allies had a vested interest in maintaining the perception of economic viability.

The state treasury needed the cash from the sale of the SOEs and the continued tax receipts from ongoing SOEs to balance the budget, the prerequisite for Western financial assistance. If the state treasury expected to sell shares to the public, particularly Polish investors, a favorable presentation of the value of the SOE was required. Presentation of an SOE in financial distress would not have encouraged investor confidence and would have impeded the transformation process. Workers had to be convinced to buy shares in the SOE where they were employed, even at a discounted price. Workers also may have rebelled if conservative accounting techniques erased all their claims to ownership. In a political environment where containment of social unrest was important, telling workers that their years of employment for low wages represented little value to the state would have been imprudent. Thus, not recognizing intangible assets and other assets that accounting does not normally recognize would have been unwise.

The requirement for Poland to adopt Western standards, particularly European Community (EC) directives and

International Accounting Standards Committee (IASC) standards, constrained accountants' choices. By accepting the price level adjustments incorporated in the GUS values, accountants presented financial statements with overvalued assets and a balance sheet that contained excess value to allow for future expectations of firm value. This may not have been unreasonable. Poland had a large domestic market with a highly educated work force and occupied a central position for distribution in Eastern Europe. Accounting regulations did not allow for the inclusion of these facts, but they were important determinants of SOE value.

Accountants used an acceptable alternative, price level adjustments to create capital. The importance of maintaining the perception of economic viability becomes even clearer when one examines the implementation of price level adjustments. When actual inflation was insufficient to raise the value to desired levels, accountants accepted adjustments in excess of the inflation rate. In 1990 fixed assets increased for all three SOEs in excess of 1,000% over 1989, while the inflation rate was 586%. The large increase in fixed assets allowed accountants to establish equity accounts. When the fixed assets increased, accountants assigned the increases to equity accounts, thus creating capital for the enterprise. Without these adjustments, the three SOEs examined would not have had any capital base.

There would not have been sufficient amounts to issue stock to investors.

A more straightforward and visible solution would have been to book goodwill for expected future earnings to reflect the new economic circumstances, but such a solution was not feasible. IASC standards and the EC Fourth Directive require the purchase of goodwill. Additionally, the five-year amortization period for goodwill imposed by the IASC and the EC would have been too short and would have negatively impacted the reporting periods immediately following privatization.

Accounting standards should reflect the country's sociocultural conditions; however, in the case of Poland, because radical economic and political change mandated foreign investment, there was pressure to import Western standards. While these standards may not have been appropriate for Poland, given its economic situation, Poland had no choice but to adopt Western standards for economic survival. The old communist economic system had collapsed, leaving the country in economic chaos. Capital rationing required that Poland conform to IMF and World Bank dictates. Poland attempted to adopt Western standards to the extent that it could without creating financial chaos.

The valuation process at the firm level varied only slightly. All three accepted the GUS values assigned to fixed assets. Most of the deviation in valuation from GUS

was reflected in the current assets. Each SOE presented a different solution to the problem of overstated current assets, yet the total difference between total assets across all three firms from GUS was just under one percent, indicating that accountants differed only in their classifications of assets and not in the substantive worth of the assets.

Krosno's accountants did not deviate from GUS in their valuation of cash and accounts receivable. The inventory account represented a slight deviation (1%), but the value of total assets did not change. The offsetting difference was absorbed within noncurrent assets.

Changes made to Prochnik's accounts for privatization increased the overall total of assets from the 1989 GUS statements by one percent. Prochnik showed very slight differences in cash. For 1987 and 1989, the cash in the prospectus was slightly less than GUS, and in 1988 the reverse was true. Minor discrepancies appeared for receivables and inventories, yet in some years there was no difference.

Tonsil's valuation represented a third variation, a slight decrease (3%) in total assets from GUS. However, the valuation of cash represented the largest deviation from GUS of all accounts across all three SOEs. Tonsil's accountants reported substantially less cash retrospectively than

prospectively. Difficulties were also apparent with inventories and receivables. Both deviated from GUS values.

After privatization, the profitability and the financial reporting practices of the three firms continued to reflect the peculiar circumstances of the Polish transition. Privatization did not have a major effect on the operating performance of the firms. The privatization process did not provide increased sources of capital for the them. The state treasury received all the cash from the sale of the stock. Privatization resulted only in increased access for these firms to debt financing. During the post-privatization period (1991-1993), the firms attempted to address the issue of overvalued current assets, but the revaluation amounts for fixed assets remained a given, and the financial reports continued to reflect the peculiarities of Polish conditions. It may take almost twenty years before the effects of the price level adjustments disappear. If the assets that were revalued have long, useful lives, depreciation schedules may extend far beyond the turn of the century.

The study of Poland's adaptation of Western standards provides empirical evidence of the difficulties of imposing standards of developed countries on developing or emerging nations. Political and economic imperatives required that Poland adopt and then adapt the standards to temper their impact on the Polish environment. The method of adaptation

commingled measurement scales and attribute measurement issues, thus reducing the usefulness of the statements. In the case of Poland, it would have been better to determine a value for goodwill and to amortize the amount over a 40-year period. This technique would have been better in the sense that it would have been more understandable and visible and less subject to attribute measurement errors. An increase in goodwill could have incorporated the firms' future potential and conveyed that to investors more clearly. But, given Poland's financial condition, greater clarity may not have been tolerated by the government.

This study should be extended to include SOEs privatized in later years (1991-1995). The changing political and economic environment, the development and promulgation of accounting principles, the development of the Polish Securities Commission, and activities on the Warsaw Stock Exchange will extend the results in this study. A comparative study of other transitional environments will expand accounting knowledge with respect to emerging economies. The different economic and political environment in the Czech Republic, Hungary, and Russia may reveal the need to use accounting differently.

Accounting is at an embryonic stage in Poland. Examining the developments in accounting within the environmental context provides a wealth of opportunity to

document and analyze the evolution of accounting in an emerging nation.

APPENDIX A
COMPARISON OF TOTAL REPORTED
ASSETS, LIABILITIES AND
EQUITIES

TOTAL REPORTED ASSETS, LIABILITIES, AND EQUITIES
1986 - 1990 (in million zlotys)

KROSNO S.A.	Dec 31, 1986	Dec 31, 1987	Dec 31, 1988	Dec 31, 1989	June 30, 1990
TOTAL ASSETS GUS PROSPECTUS	9,344	13,065 13,065	22,318 22,317	63,548 63,548	278,327
NONCURRENT ASSETS GUS PROSPECTUS	5,401	5,700 5,676	10,523 10,652	17,422 17,422	154,649
FIXED ASSETS (Srodki Trwaly) GUS PROSPECTUS	5,114	4,945 4,945	9,672 9,672	10,315 10,315	134,364
REVALUATION AMOUNT GUS PROSPECTUS			4,716 4,716		126,610
CURRENT ASSETS GUS PROSPECTUS	3,943	7,365 7,389	11,795 11,665	46,126 46,126	123,678
CASH GUS PROSPECTUS		305 305	183 183	3,685 3,685	732
ACCOUNTS RECEIVABLE GUS PROSPECTUS	1,047	2,076 2,100	4,527 4,527	23,615 23,615	40,468
INVENTORY GUS PROSPECTUS	2,896	4,984 4,984	7,085 6,955	18,826 18,826	82,478
TOTAL LIABILITIES (Prospectus)		3,992	6,881	24,867	69,646
SHORT TERM		3,731	6,161	22,476	64,643
LONG TERM		261	720	2,391	5,003
TOTAL EQUITY (Prospectus)		9,073	15,436	38,681	208,681

PROCHNIK S.A.	Dec 31, 1986	Dec 31, 1987	Dec 31, 1988	Dec 31, 1989	Sept 30, 1990
TOTAL ASSETS GUS PROSPECTUS	3,070	4,152 4,021	7,529 7,540	41,158 41,894	100,783
NONCURRENT ASSETS GUS PROSPECTUS	783	1,074 1,079	2,152 2,150	3,574 3,573	33,792
FIXED ASSETS GUS PROSPECTUS	776	1,024 1,023	1,849 1,849	1,977 1,977	27,857
REVALUATION GUS PROSPECTUS			747 747		23,183
CURRENT ASSETS GUS PROSPECTUS	2,287	3,078 2,942	5,377 5,390	37,584 38,321	66,991
CASH GUS PROSPECTUS	(2)	130 126	189 199	7,110 7,109	8,417
RECEIVABLES GUS PROSPECTUS	641	991 991	1,627 1,630	12,227 12,965	12,503
INVENTORY GUS PROSPECTUS	1,647	1,957 1,825	3,561 3,561	18,247 18,247	46,071
TOTAL LIABILITIES (PROSPECTUS)		1,064	2,844	15,536	32,478
SHORT TERM		1,044	2,824	15,526	32,468
LONG TERM		20	20	10	10
TOTAL EQUITY (PROSPECTUS)		3,704	4,696	49,541	68,305

TONSIL S.A.	Dec 31, 1986	Dec 31, 1987	Dec 31, 1988	Dec 31, 1989	June 30, 1990
TOTAL ASSETS					
GUS		4,911	9,335	55,511	
PROSPECTUS	3,542	4,744	9,170	53,554	183,804
NONCURRENT ASSETS					
GUS	1,461	1,798	3,915	7,951	
PROSPECTUS		1,784	3,906	7,961	65,413
FIXED ASSETS					
GUS	1,323	1,323	3,656	4,577	
PROSPECTUS		1,322	3,677	4,577	53,033
REVALUATION					
GUS			1,199		
PROSPECTUS			1,153		41,947
CURRENT ASSETS					
GUS	2,081	3,113	5,420	47,560	
PROSPECTUS		2,960	5,264	45,593	118,391
CASH					
GUS	2	117	194	8,897	
PROSPECTUS		57	59	1,077	3,089
RECEIVABLES					
GUS	721	1,018	2,257	25,006	
PROSPECTUS		1,099	2,413	30,903	63,509
INVENTORY					
GUS	1,358	1,978	2,969	13,657	
PROSPECTUS		1,804	2,792	13,613	51,793
TOTAL LIABILITIES (PROSPECTUS)		1,839	3,790	34,004	101,851
SHORT TERM		1,839	3,150	33,382	97,087
LONG TERM		0	640	622	4,764
PROVISIONS FOR LIABILITIES AND CHARGES		484	465	4,903	4,052
TOTAL EQUITY (PROSPECTUS)		2,421	4,915	14,647	77,901

SOURCE: Compiled from GUS statements 1987 - 1989 and individual prospectuses

APPENDIX B

BALANCE SHEET CLASSIFICATIONS USED BY
EACH SOE IN THE PROSPECTUS

PART I. KROSNO

Tangible Assets

Fixed Assets

Investments In Progress

Intangibles

Investment In Other Companies

Current Assets

Inventories and Work in Progress

Receivables

Cash

Short Term Obligations

Long Term Obligations

Funds and Results

Founding Fund

Enterprise Fund

Statutory Fund for Fixed Assets

Statutory Fund for Current Assets

Other Funds

Financial Results

PART II. PROCHNIK

Tangible Assets

- Fixed Assets
- Investments in Progress
- Capital Investments

Current Assets

- Inventories
- Receivables
- Cash
- Prepays

Owners' Equity

- Founding and Enterprise Fund
- Reevaluation
- Profit:
 - From Previous Periods
 - From Current Period

Long Term Obligations

Short Term Obligations

Unearned Revenue

PART III. TONSIL

Fixed Assets

- Tangibles Assets
- Investments

Current Assets

- Inventories
- Receivables
- Cash

Current Liabilities

Long Term Liabilities

Provisions for Liabilities and Charges

Capital and Reserves

- State Funds
- Enterprise Funds

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