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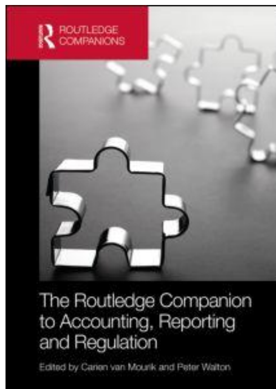

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Accounting Regulation in Emerging Markets and Newly Industrializing Countries

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Accounting Regulation in Emerging Markets and Newly Industrializing Countries

Ahsan Habib

1. Introduction

This chapter provides an overview of financial reporting regulation in emerging markets and newly industrializing countries (NICs). Emerging markets are characterized by social or business activity undergoing a rapid growth and industrialization process, assisted by government policies favoring economic liberalization and the adoption of a free-market system (Hoskisson *et al.,* 2000). NICs are countries having economies that have not yet reached developed status but have, in a macroeconomic sense, outpaced their developing counterparts (Wikipedia). The emerging market and NIC share of world gross domestic product (GDP) stood at 38 per cent in 2010, twice that in 1990. Measuring GDP at purchasing-power parity, emerging market countries actually overtook the developed world in 2008. Emerging economies attracted over half of all inflows of foreign direct investment (FDI), courtesy of these countries' fast-growing domestic markets (*The Economist*, 2011). The exact number of emerging market countries is difficult to identify precisely, since the numbers change with time. The big emerging market economies are Brazil, China, Egypt, India, Indonesia, Mexico, Philippines, Poland, Russia, and Turkey.

The spectacular economic growth registered by emerging market countries and NICs invites the question of the role of financial reporting in promoting such phenomenal growth. Financial reporting provides the primary source of independently verified information to the capital providers about the performance of managers (Sloan, 2001). This facilitates efficient resource allocation decisions by signalling changing investment opportunities to managers and outside investors, disciplining self-interested managers to invest in value-maximizing projects, and reducing firms' cost of capital (Bushman and Piotroski, 2006). Bushman and Smith (2001: 304) argue that the efficiency of capital allocation depends upon:

> the extent to which managers identify value creating and destroying opportunities, the extent to which managers are motivated to allocate capital to value creating investments and withdraw capital from value destroying investments, and the extent to which capital is available to invest in value creating opportunities.

The financial reporting system, particularly financial accounting information, is expected to facilitate capital allocation decisions through any of these channels.

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The efficient functioning of the financial reporting system, however, is contingent upon identifying the financial reporting objectives and developing a rigorous set of accounting standards that is compatible with those reporting objectives, as well as upon certain institutional factors (e.g. corporate governance, the existence and enforcement of laws governing investor protection and disclosure standards) that ensure strict enforcement of accounting standards. Emerging markets and NICs provide some very diverse and interesting insights into these issues when compared with their developed country counterparts. For example, many of the emerging market countries and NICs inherited their accounting systems from another country, but are themselves characterized by quite different reporting incentives. Additionally, most have adopted, or are going to adopt, a common set of financial reporting standards, International Financial Reporting Standards (IFRSs), designed to promote better transparency and international comparability. However, there remain serious concerns as to the applicability of a common set of reporting standards in the emerging economies and NICs, and as to whether such standards can be strictly enforced in these countries (Briston, 1978; Samuels and Oliga, 1982; Perera, 1989). Although the current structure of the International Accounting Standards Board (IASB) allows a close engagement with stakeholders around the world, the design of the reforms has usually been led by lawmakers in Europe or the United States. Consequently, representatives from emerging markets and NICs are asked to undertake sometimes costly accounting and auditing reforms which are necessitated because of crises that occur outside of their own countries (Fortin *et al.,* 2010).

This chapter proceeds as follows: Section 2 discusses the financial reporting objectives in emerging markets and NICs and how they differ from their developed country counterparts. Section 3 describes the accounting standard-setting issues for these countries with a particular emphasis on the adoption of IFRSs. Section 4 analyses the broader effect of the financial reporting regime on economic growth in emerging markets and NICs. Finally, Section 5 concludes the chapter.

2. Objectives of financial reporting in emerging markets and NICs

2.1 Financial reporting objectives in the leading conceptual frameworks

The objectives of financial reporting outlined in the leading conceptual frameworks primarily reflect user needs for accounting information, as in these illustrations:

- The primary users of general purpose financial reporting are present and potential investors, lenders and other creditors, who use that information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit (OB2) (*The International Accounting Standards Board (IASB) Conceptual Framework*).
- The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit (OB2) (*Financial Accounting Standards Board (FASB) Conceptual Framework*).

The theoretical argument supporting such an objective stems from the fact that information asymmetry between corporate managers and investors requires the former to provide financial statements prepared following generally accepted accounting principles, so that investors can assess the performance of the management group with respect to the efficient use of their resources (Jensen and Meckling, 1976).

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A contracting-based argument for the provision of financial reporting considers organizations as a contracting intermediary. All parties contracting with the firm demand information about the firm's ability to meet its contractual obligations. This contracting structure of the firm creates the fundamental demand for financial reporting and disclosure in an economy. This demand, however, is not homogeneous since published financial statements and other corporate disclosures play important economic roles in short- and long-term debt markets, in equity markets, in the evaluation and compensation of management, in labor markets, in informing major customers and suppliers, and in a variety of economic contexts. These heterogeneous uses affect the properties of the optimal accounting system and of the optimal accounting information supplied by it. Any analysis of accounting and disclosure infrastructure requirements must pay attention to heterogeneous sources of demand and cannot be restricted to the equity market (Ball, 2001).

Such a heterogeneous demand and the consequent supply of accounting information varies between the 'common law' versus the 'code law' models of financial reporting (Ball *et al.* 2003).[1] Common law reporting practices are grounded in a 'shareholder' model of reporting which assumes that ownership dispersion creates information asymmetry and thus provides opportunities for professional managers (who manage the organizations but do not control them) to deceive outside investors (who own the organizations but do not manage them). Corporate governance rights are meant to be exercised by the shareholders, and information asymmetries in these countries are more efficiently resolved through public disclosures which generate a stronger demand for published financial statements (Ali and Hwang, 2000). US and UK financial reporting practices are illustrative of common law reporting regimes. Code law countries, on the other hand, rely more on a 'stakeholder' model of governance, where information asymmetries are resolved through 'insider' communication with stakeholder representatives. Such characteristics generate a lower demand for publicly available financial statement disclosures (Ball *et al.,* 2003). China, a code law country, is illustrative of this proposition.

2.2 Unique financial reporting objectives in the emerging markets and NICs

China installed a highly centralized planned economy following the Soviet Union's socialist principles. Such a state-dominated economy encouraged the development of uniform accounting systems (UASs) serving the needs of the state for economic planning and control. These UASs were charts of accounts and detailed explanations as to how and when to use the accounts, plus detailed rules or regulations for costing, profit distribution, depreciation, and other matters. UASs used principles, concepts, and methods quite different from those widely used in market-based economies. The UASs incorporated no elements of a market economy. A nationwide hierarchical network of financial reporting was maintained through which financial statements prepared by individual companies were aggregated all the way up to the central government. The Chinese Ministry of Finance developed a conceptual framework entitled 'Accounting Standards for Business Enterprises', in 1992. The document asserts that financial accounting and reporting:

- should meet the information requirements for macroeconomic management;
- should allow relevant parties to assess the financial position and operating results of the business; and
- should meet the information needs of business management.

It is interesting that the information needs of macroeconomic management are given priority over the decision-making needs of individual investors (Xiao and Pan, 1997; Graham and Li, 1997; Zhou, 1988).

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The ownership structure of Chinese listed firms is significantly different from that of the USA or European countries. A typical Chinese company comprises three predominant groups of shareholders: the state, 'legal persons/institutions', and individuals. A distinct feature that separated the Chinese stock market from those of other countries was the creation of a split-share structure consisting of non tradable share (NTS) holders and tradable share (TS) holders.[2] This split-share structure was established in the early 1990s upon the formation of the Shanghai and Shenzhen Stock Exchanges, was intended to help raise finance for state-owned enterprises (SOEs), while retaining state control over their operation (Green *et al.,* 2010). This split-share structure constrained significantly the tradability of NTS held by the state and 'legal persons', and effectively gave the government absolute control over joint stock companies. The split-share structure arrangement has been the alleged cause of severe agency problems between controlling shareholders (NTS holders) and minority shareholders (TS holders) because of weak managerial incentives for acting in the best interest of the public shareholders, among other reasons (CSRC, 2005). Considering this split-share structure as an obstacle to the efficient functioning of the Chinese capital market, the Chinese government launched a split-share structure reform to convert publicly listed firms' NTS to TS, with the expectation that demand for publicly disclosed accounting information would increase. Green *et al.* (2010) find that both mandatory and voluntary disclosures improved in the post-reform period for firms completing this reform when compared to a matched control group of companies that had not commenced the reform. Jiang and Habib (2012) document an increase in earnings informativeness in the post-reform period attributed to the increased tradability of shares resulting from this reform.

Greece provides another example where the conventional financial reporting objectives, which are focused on the needs of investors who actively manage their portfolios in the capital markets, may not be suitable. In Greece, despite the unrestricted movement of capital between Greece and other EU nations, banks are the prominent mode of finance (Tzovas, 2006; Anagnostopoulos and Buckland, 2007). This environment encourages financial reporting that protects the interests of the creditors. By establishing a close relationship with many companies, and by owning part of a firm's capital, banks are in a position to directly obtain relevant information without having to rely on publicly disclosed accounting information (Ballas *et al.,* 2010).

Other emerging markets and NICs have financial reporting objectives which are not aligned with the reporting incentives. This is particularly the case for countries that inherited a foreign reporting system from colonial rule. For example, India, Bangladesh, and Pakistan inherited shareholder-oriented reporting objectives of British colonial origin without actually having the necessary institutional environments in terms of capital market size, maturity, activity and opportunity to diversify. For example, the capital market of Bangladesh fails to provide shareholders the opportunities to diversify risks through stock trading, because the market is driven, not by fundamental information, but rather by irrational behaviour (see section 2.3 for an example). Weak investor protection, absence of litigation, and lack of incentives for auditors to provide high quality audits result in financial statements that are not very informative for shareholders. In addition, family ownership of the organizations in these countries is dominant, and family managers tend to be less constrained by disciplinary forces and are more entrenched (Fan and Wong, 2002; Morck *et al.,* 1988).

In Latin American countries investors, banks, and other lenders rarely use financial statements to determine creditworthiness. Instead, family or personal ties, or high collateral requirements, replace financial information and market discipline in determining the prospective borrowers (Fortin *et al.,* 2010: 96). Fan and Wong (2002) find that controlling-family shareholders in East Asian countries tend to take advantage of flexibility and discretion over accounting choice and auditor selection to distort the firm's true earnings performance.

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The financial reporting objectives espoused in the IASB and FASB Conceptual Frameworks assume the presence of active markets where transactions are conducted at arm's length. However, one of the significant features of emerging market economies and NICs is the dominance of business groups which simulate an internal capital market. Granovetter (2005) argues that business groups emerge because of market failures and poor-quality legal and regulatory institutions. The role of such groups is to internalize transactions, in the absence of legal safeguards guaranteeing transactions between unaffiliated firms (Khanna and Palepu, 1997). In a recent comprehensive meta-analytic review of the impact of business group affiliation, Carney *et al.* (2011) find that, although business group affiliation diminishes firm performance in general, this is less so in countries with underdeveloped financial and labour market institutions. However, Sarkar *et al.* (2011) find that insider control exacerbates opportunistic earnings management in India, and this is more pronounced for group-affiliated firms compared to their standalone counterparts. Controlling insiders may be reluctant to provide disclosures that will make them less able to consume private benefits, even when such disclosures increase firm value and reduce the cost of capital. From a policy perspective, designing accounting standards and reporting regulations without considering this dominant form of ownership structure may lead to 'unexpected or ineffective' policy outcomes (Leuz and Wysocki, 2008).

2.3 Financial reporting objectives and capital markets

The conceptual frameworks developed by the IASB and the FASB emphasize the information provision role of financial statements for, among other things, buying, selling or holding equity or debt instruments which are carried out through organized stock markets. One of the most important functions of stock markets involves efficient allocation of capital by channelling scarce capital into businesses that need it most and withdrawing it from negative net present value projects. Markets also allow investors to trade their shares for liquidity purposes. Theory suggests that management-prepared financial statements should play a vital role for the efficient functioning of capital markets since financial reporting provides the primary source of independently verified information to the capital providers about the performance of managers (Sloan, 2001). However, such an association between the two is not obvious in some of the emerging markets and NICs.

Emerging markets vary widely with respect to the size and functioning of the stock markets. Two of the largest emerging markets, India and China, had about 5,034 and 2,063 listed companies respectively on their stock exchanges by the end of 2010. Interestingly, the number of listed companies in the Indian Stock Exchange is the largest in the world. Another emerging economy country, Thailand, shows hardly any variation in the number of listed companies over time. Market capitalization, too, varies significantly, with the Shanghai Stock Exchange alone recording a market capitalization of $2,804bn at the end of June 2011, much larger than that recorded by the Indian Stock Exchange market capitalization of $1,506bn (WFE, 2012). Table 24.1 provides a summary overview of some of the stock market indicators for some emerging market countries and NICs.

The extent to which this variation in capital market development is affected by public and private enforcement of regulatory mechanisms is an issue for policy-making at international development agencies (Jackson and Roe, 2009). These law enforcement institutions should be regarded as more important than investor protection laws (DeFond and Hung, 2004). The intensity of securities regulation can be measured by securities regulation costs as a fraction of GDP (Jackson, 2007; Coffee, 2007; Jackson and Roe, 2009). These authors document that the amount of public resources devoted to financial regulation is significantly higher in the common law countries compared to their code law counterparts (the estimation is based on major industrialized

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Table 24.1 Some key stock market indicators

Panel A: Number of listed companies including foreign companies on select emerging markets and NICs stock exchanges

Exchange	*1990*	*1995*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Americas													
Brazilian SE	579	544	467	441	412	391	388	381	350	404	392	386	381
Mexican Exchange	390	185	177	172	169	237	326	326	335	367	373	406	427
Santiago SE (Chile)	216	282	261	249	246	240	240	246	246	241	238	236	231
Asia – Pacific													
Bombay SE	NA	NA	NA	NA	NA	NA	4,730	4,763	4,796	4,887	4,921	4,955	5,034
Indonesia SE	123	237	286	315	331	333	331	336	344	383	396	398	420
National SE India	NA	NA	NA	1,041	916	911	957	1,034	1,156	1,330	1,406	1,453	1,552
Philippines SE	153	205	230	232	234	236	235	237	239	244	246	248	253
Shanghai SE	NA	NA	NA	646	715	780	837	833	842	860	864	870	894
Shenzhen SE	NA	NA	NA	508	508	505	536	544	579	670	740	830	1,169
Thailand SE	159	416	381	385	398	420	463	504	518	523	525	535	541
Europe – Africa													
Egyptian Exchange	NA	NA	NA	NA	NA	NA	795	744	595	435	373	313	228
Istanbul SE	110	205	316	311	289	285	297	304	316	319	317	315	339
Johannesburg SE	769	638	606	532	451	411	389	373	389	411	411	396	397
Moscow SE	NA	NA	NA	NA	NA	NA	NA	161	193	207	233	234	245

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Panel B: Domestic market capitalization (in USD million)

Exchange	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Americas											
Brazilian SE	226,152	186,238	121,641	226,358	330,347	474,647	710,247.4	1,369,711	591,966	1,337,247	1,545,566
Mexican Exchange	125,204	126,258	103,941	122,533	171,940	239,128	348,345.1	397,725	234,055	352,045	454,345
Santiago SE	60,400	56,310	49,828	87,508	116,924	136,493	174,418.8	212,910	131,808	230,732	341,799
Asia – Pacific											
Bombay SE	NA	NA	130,390	278,663	386,321	553,074	818,878.6	1,819,101	647,205	1,306,520	1,631,830
Indonesia SE	26,813	22,998	30,067	54,659	73,251	81,428	138,886.4	211,693	98,761	214,942	360,388
National SE India	NA	NA	112,454	252,893	363,276	515,972	774,115.6	1,660,097	600,282	1,224,806	1,596,625
Philippines SE	25,261	20,606	18,197	23,191	28,602	39,818	68,269.8	102,853	52,031	86,349	157,321
Shanghai SE	NA	NA	306,444	360,106	314,316	286,190	917,507.5	3,694,348	1,425,354	2,704,779	2,716,470
Shenzhen SE	NA	NA	156,648	152,872	133,405	115,662	227,947.3	784,519	353,430	868,374	1,311,370
Thailand SE	29,217	35,950	45,406	119,017	115,390	123,885	140,161.3	197,129	103,128	176,956	277,732
Europe - Africa											
Egyptian SE	NA	NA	NA	NA	38,533	79,509	93,496.4	139,274	85,978	91,207	84,277
Istanbul SE	69,659	47,150	34,217	68,379	98,299	161,538	162,398.9	286,572	118,328	233,997	307,052
Johannesburg SE	131,321	84,344	116,544	260,748	442,526	549,310	711,232.3	828,185	482,700	799,024	925,007
Moscow SE	NA	48,503	58,888	137,611	153,323	266,425	886,516.9	1,221,530	337,089	736,307	949,149

Table 24.2 Resource-based securities law enforcement data

Countries	*Staff per million of population*	*Budget per billion US$ of GDP*	*Public enforcement index*
Brazil	2.68	31,729	0.58
Chile	9.93	66,093	0.60
Egypt	3.65	–	0.30
Greece	12.16	60,111	0.32
India	0.43	–	0.67
Mexico	5.19	49,864	0.35
Pakistan	2.36		0.58
Peru	5.32	108,353	0.78
Philippines	4.29	65,848	0.83
Thailand	6.52	83,985	0.72
Poland	4.64	22,661	–
Turkey	6.17	58,893	0.63
USA	23.75	83,232	0.90
UK	19.04	80,902	0.68
Australia	34.44	89,217	0.90

Source: Jackson and Roe (2009), Table 2.

Note: Formal public enforcement equals the arithmetic mean of: (1) supervisor characteristics index; (2) its rule-making power index; (3) its investigative powers index; (4) orders authority index; and (5) criminal authority index, as per La Porta, Lopez-de-Silanes and Shleifer (2006).

developed countries). Table 24.2 reproduces some key indicators of resource-based regulatory intensity measures for some emerging markets and NICs from Jackson and Roe (2009).

To benchmark these numbers against the three developed countries, the input measures for the USA, the UK and Australia are also provided. Australia devotes about 35 staff per million of population to the oversight of securities regulation issues. The comparable figure for Brazil is only three.[3] Individual country studies, however, provide some evidence that regulatory sanctions by securities regulators in emerging economy countries convey valuable information. For example, Chen *et al.* (2005) find that the enforcement actions initiated by the CSRC generate negative market returns, an observation that attests to the credibility of the CSRC.

Although a well-functioning stock market has been positively linked with economic growth (e.g, Levine and Zervos, 1998; Arestis *et al.,* 2001; Beck and Levine, 2002), the role of a reliable financial reporting system in promoting a well-functioning stock market is questionable in many of the emerging markets and NICs. The recent spate of roller coaster behaviour for the Dhaka Stock Exchange (DSE) index in Bangladesh is a case in point. The market index rose by a staggering 22 per cent on a single day on 16 November 2009 because of the listing of a mobile phone company. But, by the end of 2010, it was well known that the capital markets of Bangladesh were well overvalued and overheated and they fell by 285 points on 13 December 2010, and then again by a further 551 points, the largest single day fall in the history of the DSE. The index then stood at around 8,000. The market regulatory authority, the Securities and Exchange Commission, together with the Bangladesh Bank, had relaxed its earlier conservative measures (Bangladesh Bank allowed banks to invest a tenth of their total liabilities) to boost confidence in the marketplace. However, opportunists took full advantage of this and expropriated retail

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investors' money. The market stood at around 5,500 index points in October 2011 from 8,900 a year previously and now stands at 3,534 index points. The market appears to be driven by news that is not directly relevant to company-level financial reporting. Another emerging economy market, Vietnam, is a case in point. Although market capitalization of Vietnamese stock exchanges as a percentage of GDP remains very high (39.2 per cent in 2010), the demand for financial reporting in making prudent stock trading decisions is very low. Only a third of investors analyse financial information before making investment decisions. About 40 per cent of investors are investing on basic information, and the rest invest based on what others do (Chu, 2010).

Taken together, the discussion above provides an alternative perspective on financial reporting objectives when compared to mainstream reporting objectives in providing information for decision-usefulness. Emerging markets and NICs institutional environments are characterized by the dominance of business group and family ownership structures, a feature that diminishes the role of publicly available financial information. Stock markets in some of the emerging market countries fail to perform the role of allocating capital efficiently, instead being used by powerful people to expropriate resources.

3. Accounting standard setting in emerging markets and NICs and IFRS adoption

3.1 Importance of Accounting Standards

Underpinning a system of reliable financial information is a framework of sound accounting, auditing, and reporting practices. This framework must be built using rigorous standards for accounting and auditing, skilled accountants and auditors capable of implementing those standards, and a robust enforcement regime that penalizes non-compliance (Fortin *et al.,* 2010). Financial reporting standards ensure the preparation of understandable, relevant, reliable and comparable financial statements providing information in a timely manner, with a conscious trade-off between their costs and benefits. Capital markets function more efficiently and corporate governance and regulation are more effective with credible financial reporting aided by a rigorous set of accounting standards. La Porta *et al.* (1998: 1140) suggest:

> For investors to know anything about the company they invest in, basic accounting standards are needed to render company disclosures interpretable. Even more important, contracts between managers and investors typically rely on the verifiability in courts of some measures of firms' income or assets. If a bond covenant stipulates immediate repayment when income falls below a certain level, this level of income must be verifiable for the bond contract to be enforceable even in court in principle. Accounting standards might then be necessary for financial contracting, especially if investors' rights are weak.

However, countries worldwide vary significantly with respect to the development, implementation and enforcement of accounting standards. The market-oriented common law countries rely on private sector standard setting initiatives, while the code law countries seem to accept state dominance in setting financial reporting standards. Countries that were under British colonial rule for a substantial period of time tend to use the British Company Act for the preparation of financial statements (e.g. Malaysia, India, and Pakistan). However, in most cases, the Act lacks clarity with regard to statutory requirements on disclosures in the financial statements of incorporated companies: (see World Bank, 2003, Report on the Observance of Standards and Codes (ROSC)). External auditing is mandatory, with shareholders appointing statutory auditors. Auditor rotation policy is common and, unlike the practice in South Korea, joint auditing is not required for the listed companies.

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Countries that were under non-UK colonial rule developed their financial reporting differently. For example, Mexico was colonized by Spain, a code law country, but its accounting and auditing practices have been influenced by the US GAAP, and generally accepted auditing standards (GAAS). The main reason for this trend has been the importance of foreign direct investment from the United States, as well as a trend among large Mexican publicly traded corporations towards listing in the world's largest stock exchanges in the USA (ROSC, Mexico, see World Bank, 2004). Brazil, a code law country, entrusts the Securities Commission (CVM) and stock exchanges with responsibility for developing financial reporting standards, instead of its professional accounting bodies. The Corporations Law of 1976 prescribes the accounting and financial reporting requirements for corporations. Financial statements are required to be audited by auditors registered with the Central Bank of Brazil and the Securities Commission. This is in contrast to cases where auditors need to be registered with the professional accounting body of that particular country. Under the Corporations Law, the board of directors is responsible for appointing and dismissing independent auditors.

3.2 The current trend among emerging market and NICs towards adopting IFRSs

Despite these significant differences in financial reporting regulation and audit profession development among emerging markets and NICs, one common theme that binds these countries together is their commitment to the adoption of IFRSs as the relevant accounting standards. For example, Malaysia and Indonesia have expressed their intention to fully converge their domestic accounting standards and Malaysian financial reporting standards with IFRSs. The generally accepted accounting principles in Thailand (Thai GAAP) are based on the International Accounting Standards (IASs) and IFRSs. The Russian Ministry of Finance endorsed almost all of the existing IFRSs, the Standards Interpretation Committee (SIC) and the International Financial Reporting Standards Interpretation Committee (IFRIC) interpretations for use in Russia at the end of 2011 (IASplus.com).

The rationales for adopting IFRSs as one common reporting standard are well understood. Proponents argue that the adoption of a single set of reporting standards would be particularly beneficial for emerging markets and NICs as it would:

- eliminate or reduce set-up costs in developing national accounting standards;
- attract foreign investment by the provision of comparable financial statements;
- improve the perceived quality and status of financial reports; and
- reduce the cost to firms of preparing financial statements (Nobes and Parker, 2006).

An additional incentive for emerging economies to adopt IFRSs is to attract foreign direct investment (FDI). One of the major factors that hinder the ability of many developing and emerging market countries to attract FDI is the lack of a credible reporting system. Adoption of a common set of reporting standards may partially alleviate that problem.[4] However, opponents argue that accounting and accountability problems are unique to emerging market and NICs and donor agencies should collaborate more closely with the recipient country to ensure that their assistance is delivered only in accordance with the respective national accounting development plans (Wallace and Briston, 1993).

However, the adoption of IFRSs can be regarded as a first step only. Financial reporting quality is influenced by several institutional factors, other than the quality of accounting standards, that affect the demand for and the supply of financial information, such as firm and country-level corporate governance, and the legal system. Ball *et al.* (2003) believe that although it is not

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surprising to see academic and professional accounting literatures replete with discussions on the characteristics of both accounting standards (e.g. costs and benefits associated with a particular accounting standard) and standard setting authorities, and on the variation of standards across countries, that's not the end of the story. They are of the opinion that this focus on standards is

> substantially and misleadingly incomplete, because financial reporting practice under a given set of standards is sensitive to the *incentives of the managers and auditors* responsible for financial statement preparation. Preparer incentives depend on the interplay between market and political forces in the reporting jurisdiction [italics added].

Firms' reporting incentives are shaped by many factors, including the country's legal institutions (e.g. the rule of law), the strength of the enforcement regime (e.g. auditing), capital market forces (e.g. the need to raise external capital), product market competition, and a firm's compensation, ownership and governance structure along with its operating characteristics (Hail *et al.,* 2010).

Emerging markets and NICs provide a rich laboratory for testing the incompatibilities that could arise from IFRS adoption because the reporting incentives faced by these countries are unlikely to be addressed by IFRSs. For example, Ball *et al.* (2003) use the example of four East Asian countries which imported their accounting standards from the USA, the UK and the IASB, but do not necessarily produce financial statements that share the reporting qualities envisioned by these standards. The institutional environment relevant to the application of these standards in the four countries studied is not compatible with the environment in which USA, UK, and international standards are developed. Research documents that these East Asian countries do not encourage timely recognition of economic losses, which is a crucial element of high quality financial reporting (Ball *et al.,* 2000, 2003).

3.3 Challenges associated with the successful implementation of IFRSs in emerging market countries and NICs

It is important to understand that a single set of accounting standards does not necessarily guarantee the comparability of firms' reporting practices even when the enforcement of standards is very high. Reporting comparability is unlikely to occur as long as firms' reporting incentives differ. Therefore the wholesale adoption of IFRSs will bring little benefit as long as standard setters fail to incorporate variations in reporting incentives across countries in their IFRS adoption processes. IFRS adoption will necessitate major changes in supporting institutions, as outlined by Ball (2001: 128):

> An economically efficient public financial reporting and disclosure system requires … the training an audit profession of adequate numbers, professional ability, and independence from managers to certify reliably the quality of financial statements; separating as far as possible the systems of public financial reporting and corporate income taxation, so that tax objectives do not distort financial information; reforming the structure of corporate ownership and governance to achieve an open-market process with a genuine demand for reliable public information; establishing a system for setting and maintaining high-quality, independent accounting standards; and, perhaps most important of all, establishing an effective, independent legal system for detecting and penalizing fraud, manipulation, and failure to comply with standards of accounting and other disclosure, including provision for private litigation by stockholders and lenders who are adversely affected by deficient financial reporting and disclosure.

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Many of the emerging markets and NICs encounter serious problems in initiating and sustaining the institutional changes required for the successful implementation of IFRSs.

Bangladesh, for example, has long been using IASs as the domestic accounting standards for listed companies. However, mere adoption does not guarantee successful implementation of IASs, because supportive institutional requirements are lacking. For example, an independent and competent audit profession required for successful implementation IAS/IFRSs-based reporting system is in short supply. The professional accounting institute, the Institute of Chartered Accountants of Bangladesh (ICAB) has failed to enforce its self-regulatory monitoring to improve audit quality in Bangladesh (Mir and Rahaman, 2005). Kabir *et al.* (2011) document that even Big 4-affiliated audit firms in Bangladesh fail to provide high-quality audits. This is not surprising given the lack of market demand for quality differentiated audits and a strong monitoring and enforcement regime in this country. Empirical studies from Greece show that auditors, irrespective of their Big N affiliation, fail to prevent earnings management and do not provide qualified opinions in response to managerial opportunistic behaviour in the post-IFRS regime, because of lack of incentives (Tsipouridou and Spathis, 2012).[5]

Another major challenge facing auditors with IFRS adoption relates to a substantial increase in audit risk, because auditors now have to verify more managerial judgments in the principles-based standard setting approach pursued by the IASB. Careful consideration needs to be directed at the professional accounting education systems in these countries, to assess the adequacy of auditor training in facing this challenge.

Another obstacle for the successful implementation of IFRSs in the emerging markets and NICs relates to the IASB's increasing emphasis on a fair value measurement system. The fair value concept originates in economies in which firms engage in arm's length exchanges and, thus fair value is oriented towards providing relevant information to facilitate such exchanges. However, emerging economies and NICs are characterized by an institutional environment where business transactions are often carried out within social and political networks; a feature that mitigates the benefits of a fair value-based accounting system. He *et al.* (2012) document fair value-induced earnings management practices among firms that have strong incentives to avoid reporting losses for regulatory purposes. Their findings suggest that 'intended benefits of improved transparency through [fair value accounting] FVA implementation may fail to materialize or, worse, unintended consequences such as more earnings management may arise' (ibid., p. 3).

The success of IFRS implementation also hinges on the presence of strong regulatory institutions (e.g. securities commissions, courts) and an environment with a high litigation risk. Litigation risk motivates managers to disclose their bad decisions and report their losses in a timely fashion. It also motivates auditors to ensure the transparency of financial statements (Ball, 2001). In the absence of an efficient system of private detection, and the penalization of inadequate disclosure and reporting, other institutional changes will not bring the desired benefits. An example of a low litigation environment in China follows (Liu *et al.,* 2010: 4):

> While Chinese listed companies are subject to litigation risk for misrepresentation of financial statements, it is highly unlikely that they will be sued by investors. Less than ten firms have been sued since China's two stock exchanges were established in 1990, and most of the cases involving those 10 firms are not related to auditing issues … According to the Supreme Court's *Judicial Interpretation* of January 2002, investors are not allowed to file litigation against a listed company without the CSRC first issuing a penalty announcement, even the listed company's financial statements are widely believed to be fraudulent.

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A similar low litigation risk environment exists in India where only 10 per cent of Indian listed companies have purchased a directors' and officers' liability insurance (D&O), although this number is rising since some spectacular high-tech corporate collapses in India. There has also been a spike in claims brought by shareholders in 2010, some 42 per cent. The actions arise out of mergers, takeovers, and financial disclosures (Sharma, 2010).

Fortin *et al.* (2010) identify some key challenges associated with the successful adoption of IFRSs in Latin American countries, some of which are considered as big emerging market countries. For effective and sustained implementation of the IFRSs, Fortin *et al.* (2010: 78–9) recommend that:

> the scope of application of IFRS should be limited to companies in which there is a public interest; ample transition time should be allowed for effective implementation of the standards; and an adequate mechanism for ensuring that "local IFRS" keep pace with new [IASB] standards and amendments … is required. Finally … it becomes increasingly important for [Latin American] countries to be actively engaged in the international standard-setting process, which means reviewing exposure drafts for key standards and submitting detailed comments to the IASB.

Many Latin American countries fail to adequately address these concerns.[6]

IFRS application is seen to offer the greatest advantage where countries have vibrant stock markets, demanding high quality financial reporting for the efficient allocation of capital. However, some emerging economy countries don't see the benefit of having stock exchanges. For example, the government authorities of Brunei have assessed the suitability and the need for Brunei to establish its own stock market, but opined against it. The institutional environment of Brunei is such that it appears to be easier for local companies to obtain their capital through private equity, commercial bank loans or government loan schemes (*The Brunei Times*, 2011). What is interesting though, is that Brunei has revised relevant sections of the Companies Act and made IFRS mandatory for all limited companies since 2002. Why, then, would Brunei require IFRS compliance, even though the institutional environment of that country may demand a lesser emphasis on published financial statements? Ball (2001) believes that the well-known signalling model of Spence (1973) provides a plausible answer. Ball (2001: 166–7) reasons that:

> it is essentially costless to [signal with respect to the adoption of IASs]. . . If there is no cost of signaling quality, all rational actors signal that they are high quality, so the signal loses its discriminatory informativeness. The cost to a country of adopting IAS as its accounting is economically trivial, provided it changes little else. The claim that using IAS is cheaper than using domestic standards even implies a negative signaling cost. The predicted consequence is that low-quality countries will seek to hide among high-quality countries by adopting IAS, while at the same time continuing to issue low-quality financial statements.

Lasmin (2011) offers an institutional perspective on the adoption of IFRSs by emerging market countries and NICs. The need to be socially accepted by the global community is sometimes paramount, so that the decision to adopt IFRS might not be triggered by economic reasoning alone. Most developing countries have to accept IFRS partly because of their limited ability to produce a legitimate set of standards, and partly because of their dependence on these organizations. This acceptance explains why developing countries tend to follow similar set of accounting practices to legitimize their dependence (DiMaggio and Powell, 1983).

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Taken together, the discussion in this section shows that a sound and reliable financial reporting system relies critically on the successful application of a set of standards suitable to the economic environment of individual countries. However, emerging market countries and NICs rely heavily on accounting standards developed in the Western world, which ignore the unique incentives faced by these countries. Even if the adoption of IFRS can be defended on the grounds that such adoption will increase reporting comparabilities and will affect FDI positively, these countries may lack crucial institutional support, such as a strong regulatory enforcement system and a competent and independent audit profession and, consequently, may fail to achieve the benefits to be expected from IFRS adoption.

4. Financial reporting systems and economic development in emerging markets and NICs

4.1 Financial reporting and economic growth

Do financial reporting systems impact economic growth of a country? There are considerable debates on the macro effect of financial development, a very important component of which is the financial reporting system. Lucas (1988) suggests that the role of financial intermediation in economic growth has been over-emphasized. Levine *et al.* (2000), on the other hand, show that financial development matters for economic growth. Wurgler (2000) refines this stream of research by investigating the role of financial development on capital allocation efficiency (this measure is not a direct proxy for economic growth) and finds that countries with well-developed financial intermediaries improve capital allocation efficiency. Whether financial reporting makes a positive contribution to capital allocation efficiency is investigated by Habib (2008), who finds support for this proposition.

Figure 24.1 provides an integrated depiction of the factors likely to affect a country's financial reporting regime and the ways a reporting regime might affect economic growth. There are three channels through which a high quality financial reporting regime could affect economic growth:

- better identification of good vs. bad projects;
- discipline on project selection and expropriation by managers; and
- reduction in information asymmetries.

The role of timely and credible disclosures is integral to the efficient functioning of these three channels. Corporate disclosures play a critical role in the efficient functioning of capital markets by mitigating agency conflicts among managers, majority shareholders and minority shareholders (Healy and Palepu, 2001: 406). Voluntary disclosures by management and disclosures mandated by regulations are the two primary communication vehicles shaping the corporate information environment (Beyer *et al.,* 2011: 297). The authors document that about 66 per cent of the accounting-based information explaining quarterly return variance is provided by voluntary disclosures, followed by analysts with 22 per cent, and then by mandatory disclosures.

However, it can also be argued that financial reporting quality is unrelated to economic growth. Some real world examples also support this argument. For example, big emerging economy countries like China, India, and Brazil do not have a very high quality reporting regime (Bushman and Smith, 2001; ROSC, at World Bank), yet over the past decade these countries have enjoyed phenomenal economic growth. One plausible explanation could be that these economies may be characterized more as 'insider' economies because of the prevalence of business groups, requiring less reliance on published financial reporting.

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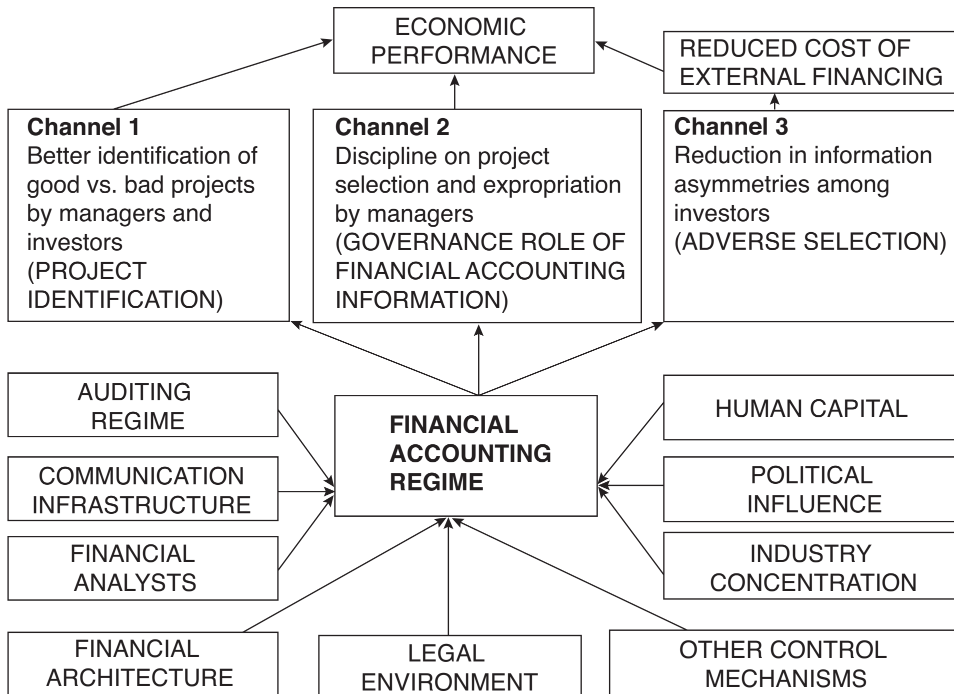

Figure 24.1 Financial reporting environment

Source: Habib (2008, p. 6), adapted from Bushman and Smith (2001, Figure 1, p. 294 and Figure 2, p. 306).

4.2 Financial reporting characteristic and growth in emerging market countries and NICs

In emerging markets and NICs, the role of corporate disclosures in promoting economic growth has seldom been systematically examined. Francis *et al.* (2005) examine the effect of external financing dependence on the incentive to make disclosures, and the consequent effect on the cost of capital, using a sample of non-US countries that included some emerging economy countries. Although the authors document a negative association between corporate disclosures and the cost of capital, the findings required a cautious interpretation because of the old sample period (1993–5) and the aggregate nature of the findings. Lopes and de Alencar (2010) used a more recent disclosure data set (1998–2005) from Brazil and document that increased disclosures reduce cost of capital. However, this finding holds only for firms with low analyst coverage and low ownership concentration. Many of the emerging economy countries do not have the strong financial analyst community that is present in the USA and the UK. Furthermore, emerging market countries and NICs are characterized by ownership concentration by family and business group affiliates.[7] Therefore, it would be premature to conclude that disclosures will reduce cost of capital in emerging markets and NICs in general and, thus, promote economic growth through a reduction in information asymmetry.

Financial accounting information is also likely to affect economic growth indirectly by performing a corporate governance role, since 'Financial accounting provides a rich set of credible variables that support a wide range of enforceable contractual arrangements and that form a basis for outsiders to monitor and discipline the investment decisions and statements of firms' managers' (Bushman *et al.*, 2011: 2). One of the desirable characteristics of an informative

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reporting environment is timely loss recognition (TLR) which requires early recognition of economic losses compared to economic gain (Basu, 1997). Managers know that TLR will force them to disclose value-destroying investments triggering intervention by outside stakeholders and, hence, discourage them from making such investments in the first place (Bushman *et al.,* 2011). The authors find that TLR disciplines investment by managers who face declining investment opportunities. However, it is not evident from the study whether such a benefit accrues to emerging markets and NICs too. Because many of the emerging markets and NICs are plagued with weak property rights (high risk of expropriation of assets by states), the disciplinary role of financial reporting is likely to be weakened (Bushman and Piotroski, 2006).

A financial reporting environment, however, is not created in a vacuum but, rather, is affected by a host of other institutional characteristics (see Figure 24.1). For example, a high quality audit contributes positively to the creation of a financial reporting system that will have a ripple effect on economic growth. Rigorously audited accounting data provide better information for identifying good and bad investments, disciplining managers, and reducing adverse selection among investors (Bushman and Smith, 2001). Research suggests that many of the emerging economy countries do not have adequate audit profession infrastructure, which may affect the credibility of financial statements.[8] Michas (2011) consulted ROSC reports, and summarized emerging market economy audit profession development (APD) under four categories and a total of 13 indicators. A brief description follows (ibid.: 1742):

Category 1 Auditor Education

(i) Are universities' accounting educational curriculum standards the same for all universities?
(ii) Are auditors required to perform on a professional examination before being licensed to practice as an auditor?
(iii) Are accountants required to gain professional experience before being licensed as an auditor?
(iv) Are auditors required to fulfil continuing education requirements on an annual basis?

Category 2 Auditing Standards

(v) To what extent are the country's auditing standards consistent with International Standards on Auditing?

Category 3 Auditor Independence

(vi) Are auditors in the country prohibited from both preparing and auditing a client's financial statements?
(vii) What is the level of liability faced by auditors in the country?
(viii) Are company audit committees responsible for appointing listed companies' external auditors?
(ix) Is auditor rotation required for external auditors of listed companies?
(x) Has the audit profession adopted the ethics code of the International Federation of Accountants?

Category 4 Auditor Oversight

(xi) Are auditors required to register with or be licensed by a central governing organization, either public or private?
(xii) What type of auditor practice reviews are mandatory within the country?
(xiii) Does an organization within the country consistently issue published audit implementation guidelines?

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Michas then scored these categories from a minimum of 0.00 to a maximum of 1.00 and termed this an APD score. Michas revealed a wide variation among the emerging market countries' APD scores. For example, Brazil scored an APD of 0.73 out of a possible 1.00, whereas her South American neighbouring nations exhibited a dismal picture (e.g. Chile and Columbia scored an APD of 0.22 and 0.06 respectively). India and Mexico scored around 0.60, which is not very impressive.

Although the discussion on the possible channels through which accounting information can help foster economic growth is important, there is very little evidence on the effect of these channels on economic growth, particularly for emerging countries and NICs. Wurgler (2000) used the sensitivity of capital investments to value-added as a proxy for economic growth and showed that emerging market countries perform much worse on the efficiency index compared to their developed country counterparts. For example, India, Chile, and Mexico had a capital allocation efficiency index of 0.10, 0.29, and 0.34 respectively compared to 0.99 and 0.84 for Germany and Austria respectively. Interestingly, these three emerging countries also scored much less on financial reporting quality than their developed country counterparts. Li and Shroff (2009) show that industries plagued with information uncertainties grow faster in countries with better quality financial reporting. Their approach considers specific channels through which financial reporting could affect economic growth.

To summarize, the controversy surrounding the role of financial reporting in promoting economic growth in countries is more acute for emerging market countries and NICs because their institutional environment does not seem to be conducive to the development of a better quality financial reporting regime. However, many of these countries have registered spectacular growth over the last decade; an anomaly that requires a more probing investigation.

5. Concluding remarks

This chapter provides an overview on the financial reporting environment in the emerging markets and NICs. The review has been organized around:

- financial reporting objectives;
- accounting standard setting and IFRS adoption; and
- the role of financial reporting in the economic development of these countries.

These countries offer an interesting platform to compare mainstream financial reporting objectives which focus mainly on the provision of decision-useful information to dispersed shareholders (FASB and ISAB Conceptual Frameworks). Stock markets play an important role for the demand of publicly available information since markets allow retail investors to trade for liquidity using accounting information. However, the institutional environment in the emerging markets and NICs is characterized by the dominance of business groups with family ownership: a feature that reduces the demand for published financial information. Although the size of the stock markets in many of these emerging economies is quite large, regulatory enforcement to protect minority investors is weak compared to their developed market counterparts, making stock markets a less reliable institution for promoting efficient allocation of capital.

Domestic standard setting organizations in many of the emerging market countries and NICs have adopted standards developed in other parts of the world without modifying the standards to suit the local economic environment. This has downplayed the role of an efficient reporting regime, characterized by a strong conceptual framework and rigorous accounting standards, in fostering economic growth. Increased globalization has left no other choice for these countries but to adopt IFRSs. However, the lack of a concomitant development of institutional

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arrangements for enforcing these standards has remained a matter of much concern. Finally, the role of financial reporting in promoting economic growth in the emerging market countries and NICs is far from being settled. Many of these countries have registered a spectacular growth over the last two decades but the role of the financial reporting regime in promoting such growth has not received much attention.

Notes

1 The argument for a legal influence on accounting practices can be traced back at least to Seidler (1967: 776) who suggested that 'the fundamental similarity in the results of the legalistic approach to the determination of accounting principles in civil law countries, such as Turkey and Italy, can be contrasted with the patterns found in common law countries such as England and the United States'. A stream of very influential research by La Porta *et al.* (1997, 1998, 2000) and parallel research by Rajan and Zingales (1998), Levine (1997), and Levine *et al.* (2000) has established that a country's legal system primarily predisposes a country towards its principal systems of finance. In particular, common law countries provide strong investor protection, which in turn is responsible for the development of strong equity markets (La Porta *et al.,* 1997: 1141–2).

2 Companies in China could issue three categories of shares. A-shares are denominated in local currency and are available to domestic investors only and traded on the Shanghai and Shenzhen Stock Exchanges. B-shares are foreign currency-denominated and are initially tailored for foreign investors. H-shares refer to the shares of companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange. Firms that issue B-shares or H-shares can also issue A-shares (dual listing). Prior to China's split-share structure reform, domestic A-shares were divided into NTS and TS. NTS holders represent the government, hold roughly a two-thirds majority, and manage the firms, while TS holders exert little power to affect the decisions made by NTS holders (Yeh *et al.,* 2009).

3 See Table 2 of Jackson and Roe (2009: 214–15). Academic work on the superiority of public versus private enforcement mechanisms provides mixed evidence. La Porta *et al.* (2006) find that private enforcement of investor protection via both disclosure and private liability rules is directly associated with financial market development, but public enforcement is not. Jackson and Roe (2009), on the other hand, find that public enforcement is as important as disclosure, and more important than private liability rules, in explaining financial market outcomes around the world.

4 Akisik (2008) reveals empirically that emerging market and transition economy countries with better reporting systems and corporate governance structures attracted more FDI.

5 Iatridis and Rouvolis (2010) examined the post-adoption effects of the implementation of IFRS in Greece and found that the effects in the official year of adoption appeared to be unfavourable but improved significantly in the subsequent period. Karampinis and Hevas (2011) found IFRS had made only a minor impact on the value relevance and conditional conservatism of accounting income.

6 One notable exception is Chile, which was the first large country in the Latin American region to adopt IFRS in full for reporting periods beginning on or after 1 January 2009. This decision, however, was taken in late 2006, by Chile's Superintendency of Securities and Insurance (SVS). To successfully implement IFRS, the SVS set up a clear and comprehensive section on IFRS on its website, issued ten circulars dealing with IFRS adoption, and conducted two surveys of securities issuers to assess their degree of preparedness for implementation (Fortin *et al.,* 2010: 86).

7 For example, the average percentage of shares owned by the three largest shareholders is 66.4 per cent for Brazil from 2004 to 2008. The comparable figure for Chile is 69.2 per cent, Czech Republic 81 per cent and Poland 59.3 per cent (Aguilera *et al.,* 2012).

8 Fan and Wong (2005), however, provide another perspective on the governance role of auditing in East Asian countries. They find that firms with ownership-induced agency problems employ high quality auditors and this is particularly pronounced for firms that raise equities frequently.

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