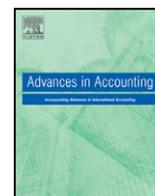




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An examination of the effect of international investors on accounting information quality in Russia

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ABSTRACT

This paper investigates the impact of international investors on the quality of financial accounting information in Russia. I hypothesize that international stock ownership leads to enhanced quality and adoptions or intentions to adopt IFRS by Russian firms. Data was gathered through face-to-face interviews with 100 Saint-Petersburg firms randomly selected from the INFOWAVE data base. The results are consistent with the hypotheses.

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1. Introduction

Measurement of accounting information quality is complex and difficult. In the past proxy measures have included relevance, conservatism, and objectivity (versus earnings management). However, accounting information quality can be also measured indirectly by investigating the motives and incentives of accounting information preparers. The demand for accounting information comes from various sources including managers, investors, lenders, employees, suppliers, customers, governments and the public (Alexander & Nobes, 2004). In addition countries' legal traditions and capital markets structure can be expected to affect the availability and quality of accounting information (Ball, Robin & Wu, 2003; La Porta, Lopez-de-Silanes, Shleifer & Vishny, 2000). This study explores the quality of accounting information in Russia using as proxies the motives and incentives of accounting information providers. Our motivation to use the Russian data is due to its world importance and because of its unique and transitional environment. Russia represents a growing market which has a significant impact on the world economy. It is a country rich in natural resources. Foreign capital is of great importance for Russian firms to develop those resources (Preobragenskaya & McGee, 2003). And, as a very large emerging market Russia offers significant opportunities for foreign investors. Furthermore, given the economy of Russia is one in transition, we can identify the impact of international investors on the quality of accounting information.

In highly sophisticated market economies the value relevance of accounting information can be studied directly by examining market share prices reactions to information releases (e.g. Ali & Hwang, 2000). In other countries, private firms may dominate the economy. In those countries, smaller companies are not traded on stock exchanges and thus direct measurement of accounting information quality is not possible. In those instances Harding and McKinnon (1997) suggest looking to the intent of accounting information preparers as a reflection of users' influence. The term "provider" or "preparer" here refers to the firm's CEO.

In conducting research of this nature, it is important to pay attention to the institutional environment of the country, which in many ways shapes the incentives of the accounting information provider (Ball et al., 2003; Bushman & Piotroski, 2006; Holthausen, 2003). In my study, I focus on CEOs relative emphasis on serving four different user groups: corporate management (for purposes of decision making support), international investors, domestic investors, and tax authorities. I contend that decision usefulness is the characteristic of financial accounting that most closely associates with information quality because it captures the concept of value relevance (Shipper & Vincent, 2003). For all Russian companies two important users of accounting information are (a) firm management and (b) the tax inspectorate (Krylova, 2003; Sucher, Kosmala, Bychkova & Jindrichovska, 2005). Emphasis on the internal decision support system can be expected to drive higher accounting information quality while emphasis on tax authorities' information needs, decidedly less so. Similarly, an emphasis on serving the interests of international investors (i.e., competing in international funds markets) is assumed to promote higher quality and transparency than an

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emphasis on serving domestic investors where competition is less. This is a fundamental assumption that supports my research.

My research examines the relative emphasis CEOs place on serving international investors vis a vis other users across categories of firms. I hypothesize and test whether emphasis on international investors associates with the adoption of (or intent to adopt) IFRS. I find positive association between international ownership of a company and the company's willingness and intent to implement IFRS. IFRS clearly require higher quality reporting than existing Russian standards.

The main contribution of this paper is identifying the impact of international investors on the quality of accounting information in Russia. Secondly, we contribute to the literature, e.g. Archer, Delvaille and McLeay (1995), by studying differences in IFRS convergence between exclusively Russian-owned and part foreign-owned firms.

The remaining of the paper is organized as follows. In Section 2 we define our proxies for accounting quality and describe financial accounting environment in Russia. Hypotheses are constructed in the Section 3 and methodology is described in Section 4. Section 5 deals with the results and Section 6 concludes the paper.

2. Accounting information quality

Accounting information is of highest quality when it supports decision making of the highest quality. Optimal decision support thus is a purpose of accounting information that corresponds to decision usefulness. If a company's CEO considers tax compliance as the main purpose for preparing accounting information, s/he might be expected to invest less in a quality information system than when the quality of her/his decisions depended on that information system. Previous research suggests that in countries where tax compliance dominates and financial accounting practices are aligned with tax practices for purposes of keeping costs low, accounting information is less value-relevant (Ali & Hwang, 2000). High conformity between financial and tax accounting compromises the value relevance of financial accounting information, as tax accounting is not designed to meet either managers or investors' needs (Young & Guenther, 2003). It also has been shown by the previous studies that Russia financial reporting practices are largely driven by tax considerations (that is, the main user and focus of accounting information is the tax inspectorate (Goncharov & Zimmermann, 2005; Krylova, 2003). It is to be expected that one witness in post-Soviet transitional economies an evolution from a dominant fixation on tax compliance to a rising relative importance of other decentralized users of information (Sucher et al., 2005). In Russia since 2002 due to the amendment in the Law on Income Taxes it has become possible to separate financial and tax accounting systems. The pace of any evolution to so decouple tax and financial accounting however is dictated by the relative importance of other users to companies; and the pace of change need not be uniform across all categories of companies or industries. For many private companies the costs of setting-up a complementary financial accounting system is high; and the benefits low. Therefore many companies continue to only provide tax based accounting statements (Krylova, 2003). I equate a continued emphasis on tax authorities' needs with low quality financial statements.

Firms, having international investors in their ownership structure will have incentives to develop high cost information systems capable of producing higher quality accounting information, because foreign investors require adherence to high information disclosure standards (Dyck, 2001). The fundamental assumption in this article is that firms to effectively compete for international funds they must first meet international investors' demands for financial statements of higher quality and transparency. Astute managers understand this reality. Specifically, as noted by McGee and Preobragenskaya (2004), international investors demand preparation of IFRS or US GAAP-based reports. Jermakowicz and Gornik-Tomaszewski (2006) report that voluntary reporting under IFRS is expected to increase significantly in coming years as more and more companies seek to raise capital in

international markets. In the last 15 years some major reforms were undertaken in Russia explicitly were aimed at improving Russian accounting standards (RAS) of practice. However, reports prepared under RAS continue to emphasize *form over substance*, which diminishes their value for potential investors. Therefore I investigate how perceived need to attract foreign investors drives managers to adoption of IFRS and thus higher quality financial statements.

2.1. Short historical perspective of accounting in Russia

Accounting in Russia has undergone some dramatic changes since 1998 when the accounting reform was launched. However, the speed of reform has been impeded by corruption; and earlier announced deadlines for IFRS implementation have not been met (Sarikas & Djatej, 2005). Recent studies have shown that a sound grasp of the legal and institutional environment of a country is crucial for an accurate understanding of incentives and constraints driving high versus low quality accounting practices (Ball, Kothari & Robin, 2000; Burgstahler, Hail & Leuz, 2006; La Porta et al., 2000). International investors operating in Russia need to recognize that the Russian business environment is not Western market capitalism, but it is a network form of capitalism (Puffer & McCarthy, 2007). The overall institutional environment in Russia is characterized by low investor protection, poor corporate governance, high levels of corruption, low levels of law enforcement, and weak enforcement mechanisms (Pistor & Xu, 2005). In the presence of weak institutional environment, reliance on enforcement mechanisms to drive change is unrealistic. Thus, firms' own incentives to produce high quality financial reports voluntarily become of great significance. I approach this issue by inquiring into the *relative* emphasis CEOs place on serving international investors as opposed to other users across categories of firms.

2.2. IFRS adoption in Russia

Extant literature on IFRS convergence is focused almost exclusively on factors influencing corporate compliance with IFRS in European countries (e.g. Dumontier & Raffournier, 1998; Street & Larson, 2004), while the literature on IFRS adoption in emerging countries is scarce (Abd-El salam & Weetman, 2003). It is widely believed that the use of IFRS in Russia will propel enhanced international investment in Russia. Accordingly, in 2004 the Russian Ministry of Finance approved Russia's transition to IFRS over the period 2004–2010. There are three main goals of IFRS implementation. Firstly IFRS are proposed for the consolidated reporting, which is currently non-existent under Russian accounting standards. Secondly, Russian accounting standards are to be developed in line with IFRS principles. Finally, an infrastructure for IFRS use and implementation is to be developed as currently there are no developed valuation markets in Russia. Accounting in Russia suffers from conflicts in tax, accounting and corporate laws.

Adoption of IFRS in Russia has been slowed down by a number of factors, such lack of availability of comprehensive education on IFRS, language problems (i.e., inadequate translations of standards) and lack of specialists (Preobragenskaya & McGee, 2003). Starting in 2005 banks and listed firms have statutory requirements to prepare reports in accordance with IFRS. Obviously, international investors favor firms that prepare their financial statements in accordance with IFRS or US GAAP (McGee & Preobragenskaya, 2004). At the same time it is understandable, why Russian companies without international investors are not eager to prepare their financial statements in accordance with IFRS, because of the additional costs associated with implementation of IFRS and because of unfamiliarity and lack of expertise in IFRS.

3. Hypotheses

The Russian economy is becoming an increasingly attractive target for foreign investors (Goriaev & Zabolkin, 2006). Even though the

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