Diversities of Accounting DisclosurePractices in International Investing

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Abstract:

Accounting diversity can have a detrimental effect on the cost of capital for these companies, and impede the successful mobilisation of targeted capital. The impact of accounting diversity on issuers and investors in the international capital markets has not been extensively studied. There are however many studies on the impact of accounting information of stockprices and values. This paper provides an overview of relevant research in this context, and discusses the issues involved. It also highlights the significant differences in accounting and disclosure practices in five select Asian countries, and identifies, accounting diversity as a factor that can affect the relative attractiveness of capital markets to international investors. Investor responses to accounting diversity and the merits of harmonization as a prescription to diversity have also been analysed.

If information available on corporate performance, as depicted by accounting numbers is distorted, and not reflective of the fundamental economic factors that affect profitability, sub-optimal investment decisions may be taken. This is particularly significant for companies seeking to raise capital across their own borders. The increased access by emerging market companies, to foreign markets, necessitate the provision of information in a manner that can be understood and analysed by the investors in the country where the issue is made.

Key words: financial markets, capital market, international investing, harmonisation.

Introduction

The globalization of financial markets, brought about primarily by increased deregulation and superior technology, has created new opportunities for international investors. Not only are more number of markets, with their unique risk-return features available for investment, but the facility for companies to seek capital beyond their borders has also increased. International investing, in ideal scenario, should lead to a higher level of integration of world markets, caused by two major factors: Firstly, the expanded opportunity set should enable evaluation of risky assets in the context of international risk factors. Secondly, any mispricing of assetsshould provide arbitrage opportunities that would disequilibrium. These in turn would enable efficient resource allocationon a global basis.Even out Evidence on the benefits of international investing falls short of such a scenario, the reason being the prevalence of barriers to free flow of funds from one market to another. Barriers may be direct, in the form of illiquid markets, poor legislative framework, etc. One such indirect barrier is the diversity in accounting principles and practices across countries. In most countries, accounting, auditing and disclosure practices are roots in local culture and law international investment requires the analysis and evaluation of information on the financial strengths of corporations spread across various countries. The quality and content offinancial statements, which contain crucial information in this respect, is critical to these investment decisions. Financial data available from various countries is not comparable because accounting rules and procedures differ from country to country.

Accounting conventions adopted by one country may be unacceptable to users of information based at another country. Analysts are known to read financial information to assess financial strength with respect to certain financial ratios, and benchmark values for these ratios. Assessment of say, the debt equity ratio, the interest coverage etc. may be hampered if the accounting figures are impacted by varying methods of accounting. In a bottom-up investment strategy, where the analyst compares companies across various countries, accounting differences may alter the understanding of the competitive edge of companies.

Impact of Accounting and Disclosure Practices on Capital Market

Empirical evidence on the impact of accounting and disclosure practices on capital markets can be reviewed under two heads: Studies that highlight the impact of accounting information on investors and studies that analyse the responses of issuers. The first strand of research mostly deals with the impact of accounting information on valuation and pricing. The second strand of research focuses on the impact of varying accounting and disclosure practices on the ability of issuers to source funds, and the impact on cost of capital.

Accounting and Disclosure Practices and Stock Prices

Security analysts provide a high level of importance to earning, asreflected in the focus on the Price-Earnings ratio as an important indicatorof value of a stock. The relationship between earning and security priceshas been the subject of extensive research. Excellent discussion of research in this area can be seen in Foster (1986). Beaver (1989) summaries the major conclusions of these studies as follows:

a. There is a significant, positive correlation between price changes and earning changes.

b. Although significant, it is not a simple one-to-one relationship.

c. Prices behave as if earnings are perceived to possess a transitory component.

d. Security prices act as though investors see through accounting method differences among firms.

e. Prices act as if accounting earnings are an important source of information, but only one of the many sources.

f. Prices can be used to forecast earnings.

g. Measures of systematic risk in security prices are positively correlated with measures of systematic volatility in accounting earnings.

The effects of accounting disclosures on stock prices, have been widely tested under the market efficiency framework. The efficient market hypothesis posits that publicly available information is almost instantaneously discounted into stock prices. There is extensive empirical evidence on the impact of accounting information on stock prices. In one of the earliest studies, Ball and Brown (1968), observed that the market's forecast of earnings was incorporated into prices, before the earnings announcement. They provided evidence that abnormal returns around earning announcement dates can be attributed to the differences between the expectation and actual performance. The direction of changes in prices was also significantly related to the direction of change in earnings. Beaver, Clarke and Wright (1979) extended the Ball Brown study to include direction as well as magnitude of change in prices, in response to accounting earnings.

Disclosure Practices in Accessing Capital Markets

The preparation and dissemination of financial information by companies involves certain costs, and in order to ensure efficient allocation of resources, the perceived benefits from this exercise should outweigh the costs involved. Most regulatory regimes impose a set of mandatory disclosures, to protect the interests of investors and aid efficient allocation of resources, by eliminating informational asymmetry.When disclosure requirements across countries vary, it may be possible for companies to seek capital from those countries where the disclosure requirements are less stringent (Biddle and Saudagaran, 1989). Foreign listings in the Euromarkets have been high owing to the less stringent disclosure norms. In comparison it is perceived that listing on the New York Stock Exchange is more difficult, owing the elaborate disclosures that are required, and the necessity to completely recast accounts to confirm with US GAAP. The Securities and Exchange Commission has observed that Foreign issuers that consider direct access to the U.S.

Capital markets through registered public offerings frequently are dissuaded by the substantial differences in disclosure standards, particularly with respect to accounting standards.

Investor Responses to Accounting Diversity

There are very few studies which have addressed the importantquestion of the response of investors to accounting diversity. The impactdiversity has on the capital market decisions of international investorshave been claborately studied by Choi and Levich (1990). The studyinvolved interviews with a sample of 52 institutional investors, corporateissuers, investment bankers, underwriters, market regulators, and ratingagencies, in five developed countries.The important findings are as follows:

1. More than half of those interviewed stated that their capital market decisions are affected by accounting diversity, this does not include those investors who had recast the financial statements of foreign companies, in order to handle problems of diversity.

2. The accounting rules that were most susceptible to variation between countries were Consolidation of accounts, Inventory valuation, foreign currency translation, provision for bad debts, long term contracts, contingencies, depreciation, goodwill, leases, and marketable securities.

3. Half of the respondents in the study reported that lack of comparable disclosure standards hindered their decisions.

4. The important areas where disclosure practices exhibited diversity were : Segment information, Method of assets valuation, foreign operations' disclosures, frequency and completeness of interim information, description of capital expenditure, hidden reserves and off balance sheet items.

Evidence of Diversity in Accounting and Disclosure

In the light of evidence that quality of accounting information affects capital market participants, we have attempted a comparative study ofaccounting practices in five Asian countries. The objective is to understand the extent of similarity in practices and to sue if diversity from established practices in the U.S. exists. The relative attractiveness of a market to a typical U.S. investor would depend upon the extent to which practices are closer to what he is familiar with.Conversely, the ability of these countries to attract portfolio flows from the U.S. would depend upon whether firms can, given the level of accounting discolors, optimise their capital costs by seeking investments from the U.S.

Implication of Accounting Diversity for Emerging Market

In the light of the empirical evidence that international investors perceive accounting diversity as a barrier to investment in a foreign market, there is a demand for harmonisation of accounting principles. Empirical evidence on the feasibilityof harmonisation and the likely benefits, is inconclusive. International organisations such as the International Accounting Standards Committee (IASC) and the International Organisation of Securities Commissioners (IOSCO) harmonization as a major facilitating factor for capital market growth and efficiency. The objectives of harmonisation would be to reduce the number of alternative accounting treatments; to add explanatory material to existing standards so as to assist practical situations of diversity; and to add to the disclosure standards so that more complete information is provided to the users. The advantages from accounting harmonization have been identified as follows: have been recommending

a. The globalisation of economics is bound to increase transnational activities of companies, and production and financing activities are expected to spread more widely across countries than ever before. Harmonisation would reduce the efforts and costs in reconciling information and analysing them,

b. Harmonization is expected to benefit developing countriessignificantly. It is expected that economic growth and increased capital market activity may not be matched by parallel growth in accounting services. The availability of standards that can be easily adapted, and the ability to draw on expertise from other countries, would facilitate the process of development, optimising on the attendant costs.

c. International, standards are expected to strengthen the process of regulation of securities markets. In a scenario of diverse practices, the stress on the regulator to be familiar with the various standards and their applications, can be of tremendous nuisance value. Standardization would facilitate not only better regulatory oversight, but also enhance co-operation amongst regulators of various countries.

Conclusion

The impact of accounting information on stock prices and the implications for allocative and information efficiency of capital markets is well documented. In a scenario of increased international investment, the diversity in accounting and reporting of information in an importantnon-tariffbarrier integration of word capital markets. Apart from impeding valuation and stock selection decisions of international investors, accounting diversity also affects the cost of capital of firms that tap the internationalmarkets for funds.

Investor responses to accounting diversity range from adopting a top down strategy to investing, to creations of capabilities for understanding diverse accounting information..Ideally, harmonization of accounting and disclosure principles should address the problems of diversity but there are doubts abet the operational feasibility of completely harmonized accounting standards. Efforts in this direction are being made, with little

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Exposure Draft ED/2019/6 Disclosure of Accounting Policies is published by the International Accounting Standards Board (Board) for comment only. The proposals may be modified in the light of comments received before being issued in final form. Comments need to be received by 29 November 2019 and should be submitted in writing to the address below, by email to commentletters@ifrs.org or electronically using our â€˜Open for comment documentsâ€™ page at: https://www.ifrs.org/projects/open-for-comment/. The growth in international business. In todayâ€™s global economy, many businesses of all sizes operate and conduct business on an international basis. World trade has grown as businesses have extended their operations beyond their own national borders, aided by technological advances in communication and data transmission, and the reduction of national barriers to commerce, trade and travel.Â standards promulgated by the International Accounting Standards Committee (IASC) standards, and the remaining 24 use some other type of accounting principles (e.g., those of another country).5. The growth in foreign company listings has been indicative of the strength and attractiveness of the U.S. capital market to those companies. International accounting diversity: does IT impact market participants? Frederick D.S. Choi Richard M. Levich. Working Paper No. 3590. NATIONAL BUREAU OF ECONOMIC RESEARCH 1050 Massachusetts Avenue Cambridge, MA 02138 January 1991.Â accounting practices, if only to maintain a Level conpetitive playing field.'Â° However, when the source of the dissimilarity relates to national tax rules, national industry practices or regulations, then as we have argued elsewhere (Choi and Levich, 1990), dissimIlar accounting treatments may be necessary [Box 0). In this case, however, direct coaparisons between firms may be difficult.Â of international investing/funding activities, and organization structure. International Accounting harmonization now is one of the most important subjects facing accounting standard setters, those who prepare or use financial statements etc. Harmonisation aims to: create consistency of laws, regulations, standards and practicesÂ If international harmonization is achieved, the level of international comparability also increases making it easier for companies to prepare the financial statements under one set of rules; investors who understand the financial statements due to the nature of IFRS and make well thought investment decisions. in the existence of harmonization, for example a parent company do more expansion by setting up subsidiaries in.