

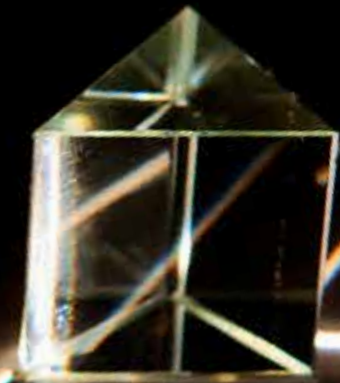


FINANCIAL
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Incentives and institutions in accounting: thinking beyond standards

Public policy paper

INFORMATION FOR BETTER MARKETS INITIATIVE



ICAEW Financial Reporting Faculty's *Information for Better Markets* thought leadership programme subjects key questions in business reporting to careful and impartial analysis so as to help achieve practical solutions to complex problems. The programme focuses on three key themes: disclosure, measurement and regulation.

This report is the third in a series of short Public Policy Papers within the *Information for Better Markets* programme. The first two reports in the series were:

- *SME accounting requirements: basing policy on evidence* (December 2015); and
- *Long-term investment and accounting: overcoming short-term bias* (April 2016).

The next report in the series is currently planned to be *Growth, development and accounting: seeing the bigger picture*.

The reports in this series are intended to contribute to a better understanding of the role of accounting in society, so that policy-making is more soundly based. They are aimed at all who have an interest in public policy debates on whether and how accounting should be regulated.

ICAEW operates under a Royal Charter, working in the public interest. As a world leading professional accounting body, ICAEW provides leadership and practical support to over 145,000 members in more than 160 countries, working with governments, regulators and industry to ensure the highest standards are maintained.

The ICAEW Financial Reporting Faculty provides its members with practical assistance and support with IFRS, UK GAAP and other aspects of business reporting. It also comments on business reporting issues on behalf of ICAEW to standard-setters and regulators.

We welcome comments and enquiries on this report and on the other aspects of the *Information for Better Markets* programme. To contact us or to learn more about our work, email bettermarkets@icaew.com or visit icaew.com/bettermarkets.

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1. Why incentives and institutions matter

Accounting is sometimes thought of as a purely mechanical activity, with right and wrong ways of doing it, which are easily distinguished. In reality, accounting in the form of financial reporting tries to portray rather vague and subjective concepts such as 'financial performance' and 'financial position'. There is a wide range of ideas about how it ought to be done, and in practice it involves a good deal of subjective judgement. Perhaps the only thing about accounting that everybody would agree on is that it should be done honestly and competently.

An important consequence of this element of subjectivity is that financial reporting requirements do not produce the same results everywhere that they apply, varying in their effects among firms and among jurisdictions. And just as financial reporting outcomes vary, so do the related costs and benefits.

To some people, all this may seem obvious, but we suspect that many are not really aware of it; and that to others it has become apparent only relatively recently, with the adoption of International Financial Reporting Standards (IFRS) in more and more countries around the world.

Before IFRS, differences in local requirements were usually seen as the main reason for disparate accounting outcomes. And those who wanted to improve financial reporting often concentrated on improving those local requirements – which in many countries were primarily accounting standards.

But while IFRS adoption has significantly improved both the quality of accounting standards in many countries and the comparability of accounts internationally, nobody would claim that every firm or every country that complies with IFRS does so with exactly the same results. In fact, adopting a uniform set of standards has had the effect of highlighting all the other things that affect accounting outcomes. These vary among firms and among countries. If we want to improve financial reporting still further, therefore, it may be more productive to focus on the other things that affect it, not just on the standards. At the macro level, this has important implications for governments and regulators. At the micro level, it has important implications for all those who have an interest in a particular firm's accounting quality.

What forces determine financial reporting outcomes at the level of the individual enterprise? In this short report, we do not attempt to answer the question comprehensively, but two commonly identified types of factor that affect financial reporting outcomes are:

- the incentives of those involved in the accounting process, especially the managers responsible for the accounts preparation; and
- surrounding institutions, which help shape incentives, and facilitate and constrain managers' actions.

We use the term 'institutions' loosely to refer to a wide range of contextual factors. Markets are institutions. The firm – as a way of doing business – is an institution. Rules and conventions – laws, regulations, standards, ethical codes and norms – and mechanisms for their enforcement are institutions. The rule of law is itself an institution. Financial reporting requirements and the mechanisms for their enforcement are institutions. The availability of different forms of finance, ownership structures, surrounding culture and technology, and competing forms of information are all institutional factors.

We distinguish 'institutions' from 'organisations'. The US Securities & Exchange Commission, for example, is an organisation. But its rules and enforcement procedures are institutions. The firm considered in the abstract is an institution. But particular firms are all organisations.

Our overall intention in this report is to improve understanding of how accounting works, by emphasising that it is not simply the mechanical application of a recipe book written by standard-setters, but to a significant degree the product of managers' judgements and preferences. Identical financial reporting requirements therefore lead to varied financial reporting outcomes, depending on the surrounding institutions and on the incentives that affect individual firms and their managers.

In the remainder of the report, we:

- look in more detail at the principal factors that affect financial reporting outcomes (section 2);
- consider some of the institutional changes involved in globalisation and how they affect accounting (section 3);
- report some key findings of research on how differences in incentives and institutions affect financial reporting outcomes, and discuss the challenges posed by these findings (section 4); and
- draw some conclusions (section 5).

To remove any uncertainties: by 'financial reporting' we mean not just a firm's annual financial statements, but any interim reports, and any announcements of financial information to be included in annual or interim accounts.

2. Key factors

Incentives and institutions interact. Institutions help shape firms' and managers' incentives, but are also affected by people's incentives and by other institutions. Where there is a demand for financial reporting information, this not only gives managers an incentive to provide it, but also makes it more likely that institutions that support such reporting – for example, effective enforcement of financial reporting requirements – will be developed.

Because incentives and institutions interact, institutions often form mutually supportive 'clusters' – groups of practices that support and are supported by particular incentives and by related institutions. This means that certain institutions tend to be found together where there is a demand for high-quality financial reporting.

Managers' incentives

Where the interests of a firm and its managers are fully aligned, managers' personal incentives in preparing the accounts perfectly complement those of the firm. This is rarely the case, except in owner-managed firms.

More commonly, where owners and managers are different people, managers' interests are not perfectly aligned with those of the firm. Managers may wish to be thought to have performed better than they actually have done – either to protect their position in the firm or to increase their rewards (or both). Researchers think of this sort of situation as an example of 'agency conflict', on the basis that managers act as agents for a firm's owners, who are their principals.

Of course, if managers behave ethically, they will act in the firm's best interests even when doing so is not perfectly aligned with their own personal interests. But because of the subjective element in financial reporting, there are many points on which it is possible, without any dishonesty, to make judgements that help to present a more favourable picture of financial performance. We all wish to appear in the best possible light, and managers preparing accounts are no exception. So their personal incentives may well be relevant to financial reporting outcomes.

Firms face rewards and punishments for their financial reporting actions, and – where the interests of firms and their managers are aligned – these provide the managers with incentives. If, for example, a firm is likely to achieve easier access to finance by providing higher-quality financial reporting, this gives its managers an incentive to do so. Where it is likely to face fines or public censure if it fails to comply with financial reporting requirements, this gives its managers an incentive to comply.

Institutions

The relevance to financial reporting outcomes of institutions specific to financial reporting – accounting requirements and the mechanisms for their enforcement – is obvious. But higher-level institutions are also important.

One of the ways that institutions help shape incentives is indirectly through their effect on investors. **Property rights**, for example, affect how economically worthwhile it is to do financial reporting. If property rights are insecure, then investors' motivation to identify investment opportunities and to monitor managers' performance will be reduced as they will be less likely to enjoy the fruits of their labours. In these circumstances, financial reporting – like many other activities – becomes less worthwhile as investors have less demand for it.

Investors' rights affect how responsive the financial reporting process is likely to be to investors' needs. If investors have the power to replace directors and auditors, for example, or to determine their remuneration, or to sue them, directors and auditors are more likely to ensure that they meet investors' demand for high-quality financial reporting information – assuming such a demand exists.

Where **insider trading** is permitted – either by law or by non-enforcement of the law – public financial reporting becomes less important as the information it discloses is likely to be reflected in market prices already, and so investors have less to gain by using it.

Where the **tax system** depends significantly on the taxation of corporate profits, it is in the interests of the government to ensure either that financial reporting operates with competence and integrity or to set up a parallel reporting system and ensure that this operates with competence and integrity. In practice, the tax system is often a compromise between these two alternatives, but it may well have implications for how financial reporting works, especially for private companies.

The **location within the broader legal framework** of financial reporting requirements and their enforcement is important. Where the requirements are set by governments (eg, as provisions of company law), they may apply to all companies and be driven by a desire to protect the rights of shareholders or creditors or to protect the tax system. Where they are set by securities regulators, they are necessarily restricted to firms whose securities are traded on regulated markets, and they tend to focus on the provision of information to ensure that stock market transactions take place at a fair price.

Where requirements are set for companies generally, this is likely to impose a constraint on their cost and complexity, as they will be applicable to small, private firms as well as to large, listed ones. Where requirements are developed purely for listed companies, this constraint is removed.

Accounting **standard-setters**, if they are effective, are never completely independent as they ultimately depend on some higher power to endorse or enforce – or perhaps merely not to object to – the standards they prepare. Their perspective on financial reporting depends on the higher power and its perspective. If their effectiveness depends on endorsement by a securities regulator, they are likely to produce the sort of standards that make sense to securities regulators – focusing on listed companies and on the provision of information intended to make sure that market transactions take place at a fair price. The institutional structure of standard setting therefore influences the sort of standards that it produces.

Another relevant question is the role of **sectoral regulators**, eg, prudential regulators for banks and insurers. Depending on their position relative to other rule-making organisations, they may either influence the financial reporting requirements of governments, securities regulators or standard-setters or they may set their own separate requirements.

There are also interactions between **financial reporting requirements** and their **enforcement**. For example, where the requirements are vigorously enforced by regulators or where questions of compliance with them are liable to lead to expensive litigation, there is likely to be a demand for relatively detailed requirements to minimise uncertainty as to whether the requirements have in fact been complied with. These aspects of financial reporting regulation are likely to reflect the broader legal framework – eg, how effective securities regulators are and how easy it is to litigate through the courts.

At the level of the individual firm, various institutions interact to help form its **corporate governance** structure. Relevant institutions include requirements on shareholders' rights, independent directors, directors' remuneration, audit committees, and external audits.

Other important institutional factors include:

- **Education.** The higher the level of education, the more people will have the skills needed to prepare, disseminate and use high quality financial reporting information. Education also supports relevant institutions such as auditing, regulation and enforcement.
- **Competition.** Financial reporting provides information about individual firms, allowing those with an interest in a firm or in transacting with it to pursue their interests more effectively. This assumes that they are free to pursue their interests in a competitive market, and the more this is the case, the stronger the demand for financial reporting information.
- **Finance.** Features of the financial system such as savings habits (eg, to what extent do people invest in the stock market?), approaches to business ownership (eg, is family ownership usual even for listed companies?), and sources of business finance (eg, is there strong reliance on bank finance?) all affect the demand for financial reporting information. The key question is whether owners and lenders have access to inside information about the firm or whether they rely on externally reported information.
- **Culture.** This is a somewhat vague concept that covers the attitudes, assumptions, preferences and practices prevalent in a society or in a section of it. Despite its vagueness, it is undeniably important, and arguably more clearly defined institutional features such as the legal framework and the financial system should be seen as aspects of culture.

Specific cultural differences that may affect the comparability of financial reporting include: concepts in accounting standards may not translate with identical meaning into other languages; and, even in the absence of translation, words and phrases in standards may be understood differently in different cultures.

- **Technology.** Information and communications technologies are particularly important for financial reporting information, affecting how it is prepared, disseminated and used.
- **Competing sources of information.** These can either be alternatives to financial reporting (reducing the incentives to provide it) or complements (increasing the incentives to provide it). Investment analysts, for example, compete with financial reporting as a source of information about listed companies, but they do not entirely replace it and are indeed, through their own demand for information and the demand they stimulate in others, likely to prompt an expansion of financial reporting disclosures.

Firms' own non-financial reporting, which has expanded rapidly in recent decades, is a competing source of information. Others include inside sources (leading to insider trading in the case of listed companies), reports of credit-rating agencies, and – for private companies – tax returns.

Sometimes these competing sources turn out to be variants of financial reporting information. Insider traders and, in some jurisdictions, investment analysts may simply have early access to financial reporting news, credit-rating agencies may rely on seeing firms' accounts, and tax returns too must rely on firms' own accounting. So a firm's accounting information often underlies other, apparently independent sources.

3. Globalisation and institutional change

In this section we consider some of the institutional changes involved in globalisation and how they affect accounting. The increasing globalisation of markets is itself an institutional change that has had important consequences for financial reporting. Removal of restrictions on capital flows, in particular, has facilitated an extraordinary growth in international capital markets, which in turn has prompted a demand for financial reporting information that can be understood by investors around the world. IFRS is a response to this demand.

At the same time, although probably less significantly for financial reporting, removal of restrictions on international flows of goods and services has made it more important that firms transacting across international boundaries can understand one another's financial position, so that they can do business with confidence. IFRS is also a response to this demand for an international language of business.

These institutional changes do not affect all businesses equally. International accounting standards are more relevant for firms that wish to raise capital on international markets or to trade internationally than for those whose focus is purely domestic. National authorities, when deciding whether or how far to adopt IFRS, may well therefore limit its scope to only those firms for which it seems most relevant.

Because the costs and benefits of particular financial reporting practices vary with surrounding institutions and incentives, it is highly unlikely that any single set of accounting standards will be the best for every country in the world considering each country in isolation. But increasing globalisation means that the advantages to countries of thinking about what would be best for them in isolation are diminishing relative to the advantages of thinking about what would be best for them as participants in global markets.

The costs and benefits of adopting international standards therefore vary from country to country. We may expect, for example, that countries that are less dependent on international capital flows or on international trade would see, relatively speaking, less to be gained by adopting international standards. Countries that already have financial reporting standards that are understood by international investors and that are regarded as high quality also have less incentive to move to IFRS. All these considerations mean that for the US IFRS adoption may well be less attractive than for other jurisdictions. In a World Bank survey of dependence on international trade in goods the US comes 174th out of 178 countries. It has the world's largest domestic capital markets. Its financial reporting for capital markets has long been regarded as the best in the world. But even in the US there are pressures for internationalisation.

Local differences in institutions may also mean that where countries adopt IFRS they do so with local limitations or adjustments. In the EU, for example, where individual company accounts are typically the basis for calculating taxes on corporate income, the EU-level requirement for IFRS is limited to consolidated accounts, leaving the position for individual company accounts to be settled by national authorities. In China, where IFRS has not been adopted but has been adapted as the basis for national standards, a significant institutional difference is that asset markets are less developed than in some other countries, which is perhaps a cause of the lower use of fair value requirements in China.

Local institutional differences are therefore a threat to the adoption of uniform accounting standards globally. However, such differences also mean that even where uniform accounting standards are adopted, outcomes are likely to vary because of differences in, for example, local ownership structures and enforcement regimes.

The International Accounting Standards Board (IASB) has sometimes reacted to problems that arise from institutional differences among countries, including the strength of particular sectors in some countries, by amending its standards to accommodate them. Related party transactions (China), agriculture (South-East Asia) and rate-regulated activities (North America) are all areas where arguably this has happened, although views will no doubt differ on how appropriate the IASB's solution has been in each case. The IASB's principles-based approach,

which allows a degree of flexibility for local interpretation, could also be seen as a way of reconciling national differences. This may well be a sensible strategy for an international standard-setter that ultimately depends for its success on acceptance by the national authorities of countries with very diverse institutions.

The IASB is also increasingly working with national standard-setters and regional groupings of standard-setters – a recognition of the need to accommodate the variety of institutional settings around the world and a move that we welcomed in our 2012 report *The future of IFRS*.

4. The challenges posed by empirical research findings

It is a commonplace in empirical accounting research that incentives and institutions affect financial reporting outcomes. The literature on this subject is vast, and we will not attempt to summarise it here, but will simply highlight some of its more significant findings – although they are not necessarily accepted by all researchers.

These findings pose challenges for various groups involved in the financial reporting process, which we discuss at the end of this section. Details of the supporting research appear in the appendix.

The findings of research

All the findings referred to below relate to averages for populations of firms. So when researchers find, for example, that ‘earnings tend to be managed’, this does not tell us how many firms are managing earnings or how much they are doing it. It just means that enough firms in the sample population appear to be doing it, and to a great enough extent, to produce a statistically significant result. It is possible that most firms in the sample are not doing it at all.

While for some readers of this report, such an approach may seem to be unsatisfactory, statistical analyses impose greater rigour in establishing cause and effect than would otherwise be possible. In medicine, for example, links between individual behaviour or environmental factors and specific diseases cannot be established by arguments based on anecdotes from personal experience. Only statistical techniques can establish causal connections in such cases, and even then only as probabilities.

Findings reported by accounting researchers include the following.

The terms of **managers’ remuneration** can affect accounting incentives.

- Where managers’ bonuses are affected by reported earnings, earnings tend to be managed so as to increase bonuses.
- Where managers’ bonuses are affected by share prices, earnings tend to be managed so as to increase bonuses or to make them less volatile.

The terms of **debt covenants** can affect accounting incentives.

- Some researchers have found evidence that earnings tend to be managed so as to avoid breaching debt covenants, although other researchers consider this unlikely.

Features of **firm performance** can affect accounting incentives.

- Earnings tend to be managed so as to avoid losses and falls in profits, and so to meet or beat market expectations.

‘Political costs’ can affect accounting incentives.

- Earnings tend to be managed down where there are political reasons to do so: eg, by firms whose profits are regulated, firms that fear regulation or confiscation of profits, and firms arguing that they face unfair competition.

Tax can affect accounting incentives where taxable profits and reported profits are linked.

- Accounting policy changes are sometimes made in order to reduce tax payments.

A firm’s **ownership structure** can affect accounting incentives.

- Family-dominated listed companies tend to manage earnings less than others, presumably because they are less concerned about outsiders’ reactions to the firm’s results.
- State-owned firms show lower accounting quality than firms with outside ownership, presumably because the owners are less reliant on financial reporting information.

Ownership structures differ among countries, as well as among firms, and countries have been divided, partly on this basis, into **insider and outsider economies**.

- ‘Outsider’ economies (with relatively dispersed ownership, strong investor protection and large stock markets) have lower levels of earnings management by listed firms than ‘insider’ economies (with relatively concentrated ownership, weak investor protection and less developed stock markets).
- Even high quality financial reporting standards do not lead to high quality financial reporting by listed firms in countries where there is relatively low demand for it, eg, because firms rely on ‘insider’ sources of finance, which receive information about the firm privately, not through public financial reporting.

Auditing can affect accounting incentives.

- There tends to be less earnings management where auditing is of high quality.

Corporate governance can affect accounting incentives.

- There is some evidence that earnings management tends to be lower where corporate governance quality is high, but research results on this topic are even more mixed than usual.

Effective **enforcement** can affect accounting incentives. Studies on this topic sometimes include auditing as an aspect of enforcement.

- Listed firms in countries with strong judicial systems reflect bad news in earnings faster than firms in countries with weaker judicial systems.
- When the EU made IFRS mandatory for listed companies, improvements in market liquidity (a sign of increased transparency) were restricted to those countries that improved financial reporting enforcement at the same time.
- Among countries that made IFRS mandatory (not just the EU) improvements in analysts’ forecasts – another sign of financial reporting transparency – were correlated with the countries where there were also improvements in enforcement.
- Also among countries that made IFRS mandatory, reductions in the cost of capital and increases in cross-border investment were found only for countries with strong enforcement.

Undertaking **equity market transactions** can affect accounting incentives.

- Earnings tend to be managed upwards around the time that listed companies issue fresh capital to the market (‘seasoned equity offerings’).
- Earnings tend to be managed upwards by firms before they make equity-financed takeovers.

Private companies have different accounting incentives from listed ones.

- In a country where all companies are subject to the same accounting standards, private companies show lower accounting quality than listed companies, presumably because there is a lower demand for high quality financial reporting information about private companies.

An important point relevant to many of these findings is that what appear to be ‘bad’ outcomes may not be. ‘Good’ outcomes such as higher accounting quality have costs and the question is whether the benefits exceed the costs. Lower accounting quality for private companies, for example, may well be an appropriate outcome where the costs of increasing quality outweigh the benefits.

We give details in the appendix of research papers supporting these findings.

Challenges

The findings of research pose challenges for various parties interested in the financial reporting process.

Users need to be aware of potential biases, created by varying incentives and institutions, in the information they use.

Preparers need to consider whether they wish to signal that they are not in fact subject to the biases that users may assume affect their financial reporting. This may, for example, lead them to take corporate governance measures designed to support high-quality reporting and to disclose that they have done so.

Auditors need to consider what potential biases may affect the information on which they are reporting and, where appropriate, take measures to mitigate the risks.

Standard-setters need to consider whether differences in incentives and institutions indicate a need for differential requirements in standards for different classes of firms.

Regulators need to consider whether additional measures – eg, more rigorous enforcement – are needed to counter the potential effects of incentives and institutions that may bias financial reporting. However, they also need to consider whether the biases are in fact an optimal outcome, reflecting underlying differences in the demand for information.

5. Conclusions

On a naive view of financial reporting, how it is done is determined simply by the requirements that govern it; for listed companies these days the key requirements are usually accounting standards. In fact, because of the subjective choices that accounting inevitably involves, it is shaped by a variety of different contextual features. A full understanding of how financial reporting works in practice therefore requires a full understanding of its context: the relevant institutions and the incentives of particular firms and their managers. This message emerges clearly from the research surveyed in our 2015 report *The effects of mandatory IFRS reporting in the EU: a review of empirical research*.

As the incentives and institutions that influence accounting outcomes vary among firms and among jurisdictions, it is unrealistic to expect financial reporting around the world to be completely comparable. This does not mean that we should not seek agreement on international accounting standards, but it does mean that the goal is increased comparability – or maintaining an achieved level of increased comparability – rather than complete comparability.

And if we want to improve the quality of financial reporting, we need to think about not only the technical requirements that govern it, but also the incentives of those who prepare accounts and the surrounding institutions – auditing, corporate governance, enforcement, the legal system, the educational system, and so on. This implies that there are benefits in a regulatory structure that, as with the UK's Financial Reporting Council, has responsibility for auditing and corporate governance as well as for financial reporting, and for enforcement as well as for rule making.

This way of thinking about financial reporting brings greater realism, but also greater complexity, to the task of deciding what the content of financial reporting requirements should be and how they should be enforced. What is clear is that financial reporting needs to be thought about in its context. This creates challenges both for those who wish to understand it through research and for those who engage in policy debates on how and whether it should be reformed. They need to disentangle, so far as this is possible, the effects of financial reporting requirements, their enforcement, and other contextual factors.

Globalisation of capital and product markets will continue to exert pressure for increasing international comparability in financial reporting. However, because of continuing institutional differences between countries:

- some countries may not adopt IFRS in the near future;
- some countries are likely to want to keep at least some differences in local requirements;
- to discourage local differences, IFRS may be amended to reflect issues that are of primarily local importance; and
- comparability of IFRS financial statements will be affected.

Because of differences in incentives at the firm level:

- countries are unlikely to require IFRS as issued by the IASB to be adopted by all firms regardless of size, ownership and legal status; and
- comparability of financial statements will be affected. This is true for all financial reporting requirements, not just IFRS.

The issues discussed in this report pose challenges for policy makers, accounting researchers, and others who are interested in public policy debates on accounting requirements. In particular, they imply that public policy debates should focus on the incentives and institutions that support financial reporting quality as well as on accounting standards. They imply too that countries considering adopting IFRS need to look at other institutions if they are to obtain the full benefits of adoption. We would welcome comments on these issues and other questions raised by the report and its conclusions. Please send them to bettermarkets@icaew.com.

Appendix: research evidence

Introduction

The literature on how incentives and institutions affect financial reporting outcomes is vast. In this appendix we can do little more than scratch the surface.

In section 3 of the report we look at the institutional changes associated with globalisation and their impact on the demand for international accounting standards. We refer to some of the most important research papers on this topic in **Globalisation and international accounting standards** below.

In section 4 of the report we summarise a number of research findings, not necessarily accepted by all researchers, on the effects of incentives and institutions. In **The effects of incentives and institutions on financial reporting** below, we refer to research papers supporting these findings.

In **Institutions** (see page 22), we discuss the varying meanings attached by researchers to the term 'institution' (see page 20).

In **Institutional interdependence** (see page 25), we draw attention to researchers' comments on the policy making problems implied by institutional interdependence.

In **National accounting systems: classification** (see page 25), we mention briefly the research literature categorising different groups of national accounting systems.

Many of the papers that we refer to below look at earnings management. We restrict ourselves here to reporting whether, in such cases, evidence of earnings management has been found by researchers. It is a separate question, and usually a controversial one, whether the earnings management has an effect on capital markets – ie, whether investors are 'taken in' by it or 'see through' it. The answer may well vary from case to case.

Globalisation and international accounting standards

The challenges, costs and benefits of adopting common standards across jurisdictions with varying incentives and institutions have been explored in a number of papers, including **Ball (1995)**, **Sunder (2002)**, **Schipper (2005)**, **Ball (2006)**, **Zeff (2007)**, **Carmona and Trombetta (2008)**, **Leuz (2010)**, **Walker (2010)** and **Ball (2016)**.

Hail et al (2010) consider the specific institutional challenges of potential IFRS adoption by the US; **De Lange and Howieson (2006)**, on the basis of institutional considerations, express scepticism about the prospects of US adoption.

Previous discussions of this subject by ICAEW include **ICAEW (2012)** and **ICAEW (2015)**, *Moving to IFRS reporting*.

The problems of translation are an issue that arises in connection with international accounting standards (mentioned in section 2 of the report), and **Zeff (2007)** draws attention to them.

Evans et al (2015) provide a general discussion; **Baskerville and Evans (2011)** consider issues arising on the translation of IFRS; and there are a number of papers on the translation of particular accounting terms or on translating accounting terms into particular languages. For example, **Alexander (1993)** looks at the French and German translations of 'true and fair' and **Dahlgren and Nilsson (2012)** look at translating IFRS into Swedish.

The effects of incentives and institutions on financial reporting

Introduction

As we have noted, the literature on the effects of incentives and institutions on financial reporting outcomes is vast. Moreover, the number of institutions that have been found to have an effect has mushroomed. **Isidro et al (2015)**, reported in **Leuz and Wysocki (2016)**, identify more than 70 country-level institutional variables in accounting research. This proliferation perhaps reflects, among other things, uncertainties both as to what 'institutions' are in general

(see **Institutions** – page 22), and as to what constitutes a discrete institution in particular cases. What follows is just a small selection of relevant research, focusing on the findings referred to in section 4 of the report.

Before we review the findings of research on the effects of incentives and institutions on financial reporting outcomes, it may be helpful to draw attention to some aspects of how accounting researchers address these questions.

Earnings management. Researchers look at accruals – the difference between earnings and cash flows – to judge whether preparers are managing earnings upwards or downwards. This involves an estimate of what the difference should be in the absence of earnings management, which gives a figure of ‘normal accruals’. The gap between normal accruals and the actual difference between earnings and cash flows gives a figure for ‘discretionary accruals’ – a measure of earnings management.

Conservatism. Preparers can employ varying degrees of conservatism in how they measure assets and liabilities, and in how quickly they recognise profits and losses (‘timely loss recognition’).

Accounting quality (or earnings quality). This general concept is measured by researchers in a number of ways. One way is to look at the extent of discretionary accruals – regarded as an indication of low quality. Another is to look at the extent of smoothing of earnings – again taken as an indication of low quality. Yet another is to look at the extent of accounting conservatism or timely loss recognition – regarded as indications of high quality. Measures of accounting quality therefore include measures of earnings management and accounting conservatism.

Disclosures. Research on disclosures is not usually restricted to financial reporting disclosures.

Inferences from capital market effects. Changes in the characteristics of financial reporting are sometimes inferred from its capital market effects. For example, an increase in capital market liquidity may be a consequence, and therefore an indication, of increased transparency.

Inferences from analysts’ forecasts. Changes in the characteristics of financial reporting are also sometimes inferred from its effects on investment analysts’ forecasts. Greater forecast accuracy or reduced forecast dispersion may be a consequence, and therefore an indication, of increased transparency.

Managers’ remuneration

Healy (1985) looks at accounting-based bonus plans for a sample of US firms over the period 1930–1980. Some of the plans have upper bounds, so that however much the firm earns above the bound, the manager’s bonus stays the same. This gives managers an incentive to reach the upper bound but to defer recognition of any gains above that to another year (through income-decreasing accruals). All the plans have lower bounds, so that if the firm’s earnings are below the lower bound, the manager does not earn a bonus. This gives managers an incentive to exceed the lower bound but, if they know that earnings will not reach it, to reduce earnings in the current year (through income-decreasing accruals) so as to increase them in later years.

The author finds that:

‘Managers are more likely to choose income-decreasing accruals when their bonus plan upper or lower bounds are binding, and income-increasing accruals when these bounds are not binding’.

Holthausen et al (1995) look at accounting-based bonus plans for a sample of US firms over the period 1982–1990. They question the findings of Healy (1985) for manipulation where earnings fall below the lower bound, but have similar findings regarding earnings above the upper bound. They point out reasons why it might not be sensible for managers to report lower earnings than necessary below the lower bound:

- if the results look too bad, the managers could be dismissed; and
- poor results might infringe debt covenants.

Since the 1980s, management bonuses have shifted significantly from accounting-based measures, and payment has shifted from cash to equity, directing managers’ attention to share prices.

Cheng and Warfield (2005) look at a sample of US firms over the period 1993–2000. ‘As expected’, they write:

‘we find that managers with high equity incentives are more likely to report earnings that meet or just beat analysts’ forecasts. We also find that managers

with consistently high equity incentives are less likely to report large positive earnings surprises. This finding is consistent with the wealth of these managers being more sensitive to future stock performance, which leads to increased reserving of current earnings to avoid future earnings disappointments.'

Bergstrasser and Philippon (2006) look at a sample of US firms over the period 1993–2001. They:

'find evidence that more 'incentivised' CEOs – those whose overall compensation is more sensitive to company share prices – lead companies with higher levels of earnings management. [They] go on to document that periods of high accruals coincide with unusually large option exercise by CEOs and significant unloading of shares by CEOs and other top executives.'

The literature on this subject, including references to a number of other papers, is reviewed in **Fields et al (2001)**, section 4.2.1, **Dechow et al (2010)**, section 5.3, and **Walker (2013)**, section 6.2.

Debt covenants

Early evidence on debt covenants and earnings management tended to find a relationship between them. **Watts and Zimmerman (1990)** conclude that the evidence at that date 'is generally consistent with the debt/equity hypothesis. The higher firms' debt/equity ratios, the more likely managers choose income increasing methods.'

Later reviews have more qualified conclusions. **Fields et al (2001)** state that 'the evidence on whether accounting choices are motivated by debt covenant concerns is inconclusive', but then add:

'although we cannot draw definitive inferences about the impact of debt covenants on accounting choice, there is certainly a significant amount of data suggesting a relation between accounting choice and violation of debt covenants.'

Dechow et al (2010) are clear that 'higher leverage is associated with lower quality', but are uncertain 'whether the lower quality is due to closeness to covenants'.

Walker (2013)'s review is sceptical in tone, and he points out that:

- 'rational debtholders will not agree to contracts that expose them to massive transfers of wealth by virtue of accounting choice'; and
- 'for most firms debt contracts are not a one-shot game. Most firms will want to borrow again in the future. They will also know that if they behave opportunistically towards their current debtholders then it will become more generally known.'

Shivakumar (2013) also reviews the literature on this question and overall suggests that there is evidence that debt contracting affects firms' earnings management. **Taylor (2013)** cites further evidence on this point.

Firm performance

There is evidence that preparers manage earnings in various circumstances related to perceptions of firm performance. In particular, they tend to manage earnings to avoid losses, to avoid falls in earnings (smoothing) and to meet expectations. These forms of earnings management reflect various incentives. To a large extent they probably reflect managers' wish to protect their reputations and their jobs. But they may also reflect fear of litigation, particularly in the case of meeting managers' own earnings forecasts. And they may reflect incentives to keep up share prices. For example:

- **Barth et al (1999)** find that 'firms with patterns of increasing earnings have higher price-earnings multiples than other firms', but that 'price-earnings multiples decline significantly when earnings decrease after a previous pattern of increasing earnings'; and
- **Bartov et al (2002)** find that 'firms that manage to meet or beat [investment analysts'] earnings expectations enjoy an average quarterly return that is higher by almost 3% than their peers that fail to do so.'

Earnings management is not the subject of **Hayn (1995)**, but the author draws attention to a curious feature in the distribution of profits and losses in her sample (US firms over the period 1962–1990):

‘Interestingly, there is a point of discontinuity around zero. Specifically, there is a concentration of cases just above zero, while there are fewer than expected cases (assuming [a] normal distribution) of small losses (ie, just below zero)... These results suggest that firms whose earnings are expected to fall just below the zero earnings point engage in earnings manipulations to help them cross the “red line” for the year.’

Burgstahler and Dichev (1997) look at a sample of US firms for the period 1976–1994. They find:

‘evidence that firms manage reported earnings to avoid earnings decreases and losses. Specifically, in ... distributions of earnings changes and earnings, we find unusually low frequencies of small decreases in earnings and small losses and unusually high frequencies of small increases in earnings and small positive income. We find evidence that two components of earnings, cash flow from operations and changes in working capital, are used to achieve increases in earnings.’

DeFond and Park (1997) look at a sample of US firms for the period 1984–1994. Their evidence:

‘suggests that when current earnings are “poor” and expected future earnings are “good”, managers “borrow” earnings from the future for use in the current period. Conversely, when current earnings are “good” and expected future earnings are “poor” managers “save” current earnings for possible use in the future.’

The ‘borrowing’ and ‘saving’ of future earnings are achieved through discretionary accruals. The authors caution that they cannot rule out that their findings are the result of selection bias.

Kasznik (1999) looks at a sample of US firms for the period 1987–1991. He finds:

‘evidence consistent with the prediction that managers use positive discretionary accruals to manage reported earnings upward when earnings would otherwise fall below management’s earnings forecasts ... [but] there is no evidence that managers who have underestimated earnings manage reported earnings downwards’.

Payne and Robb (2000) look at a sample of US firms for the period 1986–1997. They write:

‘We predict that managers will move earnings towards analysts’ forecasts when premanaged earnings¹ are below market expectations. This prediction is supported. When premanaged earnings exceed analysts’ forecasts, ... [they find evidence consistent with] an incentive to “store up” discretionary accruals for future periods by employing income-decreasing accruals (thereby reducing analysts’ forecast errors).’

Gilliam et al (2015) find that the discontinuity in earnings around zero disappeared in the US after passage of the Sarbanes-Oxley Act in 2002 and has not reappeared since. On the face of it, this provides interesting evidence of the effectiveness of regulation.

The literature on this subject, including references to a number of other papers, is reviewed in **Fields et al (2001)**, section 4.3.2, and **Walker (2013)**, section 6.3.5.

Political costs

One category of incentives that accounting researchers study is ‘political costs’; it covers various incentives that relate in one way or another to governmental interference or to securing or avoiding it.

As described by **Watts and Zimmerman (1990)**, ‘The political cost hypothesis predicts that large firms rather than small firms are more likely to use accounting choices that reduce reported profits’. The rationale for this is that large firms’ profits are more likely to attract political attention leading to, eg, break up (if there is found to be a monopoly), price regulation (or tougher price regulation), or higher taxes. The authors conclude that ‘The evidence is consistent with the political cost hypothesis’, but add that ‘the result only appears to hold for the largest firms ... and is driven by the oil and gas industry’.

Cahan (1992), using a sample of 15 US antitrust investigations between 1970 and 1983, looks at the effects of such investigations on firms’ discretionary accruals. He finds that ‘discretionary accruals [and therefore earnings to the extent they are affected by discretionary accruals] were lower while the firm was being investigated’.

¹ That is, earnings before discretionary accruals (or earnings before they have been managed).

Watts and Zimmerman (1986) (p362), hypothesise that ‘consumer product firms with rapid product price increases are more politically susceptible than other firms and therefore more likely to change accounting procedures to reduce reported profits’, and suggest that this should be investigated. **Han and Wang (1998)** investigate the hypothesis by looking at US oil firms at a time of rapidly rising oil prices during the 1990 Persian Gulf crisis. They find that ‘oil firms that expected to profit from the crisis used accruals to reduce their reported quarterly earnings during the Gulf crisis’. They also find that ‘the tendency to release good earnings news early, documented in prior research, is reversed for oil firms during the Gulf crisis’.

Accounting may also be affected by a wish to secure political interventions. **Jones (1991)** ‘tests whether firms that would benefit from import relief (eg, tariff increases and quota reductions) attempt to decrease earnings through earnings management during import relief investigations by the United States International Trade Commission (ITC).’ Based on five ITC investigations between 1980 and 1985, she finds that they do.

There is further discussion on this subject, including references to a number of other papers, in **Fields et al (2001)**, section 4.4.2, and **Walker (2013)**, section 6.

Tax

Dopuch and Pincus (1988) look at a sample of US companies for 1962–1981. They find evidence supporting the hypothesis that inventory accounting method choices are made for tax purposes.

Ali and Hwang (2000) address the effects of a number of institutional factors, including tax. As the title of their paper indicates, they look at ‘country-specific factors related to financial reporting and the value relevance of accounting data’. Their sample comprises data from manufacturing firms in 16 countries for the period 1986–1995. They find that:

‘the value relevance of financial reports is lower for countries where the financial systems are bank oriented rather than market oriented; where private sector-bodies are not involved in the standard-setting process; where accounting practices follow the Continental [European] model as opposed to the British-American model; **where tax rules have a greater influence on financial accounting measurements** [emphasis added]; and where spending on auditing services is relatively low.’

Value relevance measures the correlations between financial reporting information and stock market prices or changes in stock market prices. The assumption is that where value relevance is higher the information is likely to be more useful, at least for stock market investors. As indicated above, the authors look at five types of country differences:

- **Bank-orientated v market-orientated financial system.** Where firms are financed predominantly by banks, public sources of information such as financial reporting are likely to be less important as banks are assumed to have access to private information about the firms they finance.
- **Private sector involvement in standard-setting.** Where governments set accounting standards it is assumed that they will give priority to governmental objectives such as the needs of the tax system or compliance with governmental plans and policies, rather than the needs of capital markets.
- **Continental-model v British-American-model countries.** As discussed in National accounting systems: classification (see page 25), various classification systems exist for countries’ accounting requirements and practices. One classification system includes ‘Continental’ and ‘British-American’ categories. This type of country difference presumably overlaps with the four other types used in **Ali and Hwang (2000)**. The British-American model attaches more importance than the Continental model to financial reporting information for investors.
- **Influence of tax rules on accounting measurements.** This appears to overlap with the two previous types of difference. Where the focus of accounting rules is to provide a figure of taxable profit, less importance is attached to the importance of financial reporting information for investors.
- **Spending on audit services.** This is taken to be an indicator of the importance attached to financial reporting.

The literature on the effects of tax on financial reporting, including references to a number of other papers, is reviewed in **Fields et al (2001)**, section 4.4.1, and **Dechow et al (2010)**, section 5.6. **ICAEW (2015)**, *SME accounting requirements*, Appendix, section A4.3, refers to papers finding evidence from Germany and Slovenia that SMEs use write-downs to reduce their tax bills.

Ownership structure

Family ownership

There is evidence from various countries that family firms show higher reporting quality. 'Family companies' are a difficult-to-define category, and are usually defined in a way that includes listed companies where there is a dominant family as well as private companies. Definitions can also vary across countries. The majority of the research surveyed in **Prencipe et al (2014)**, a review paper, finds that family ownership is associated with higher accounting quality – a surprising result given the generally accepted view that the incentives for high-quality financial reporting are reduced where firms are dominated by a small group of insiders. The papers discussed by **Cascino et al (2013)**, who provide a briefer review on this particular topic, give a similar picture on balance.

Government ownership

Lee et al (2013) look at accounting standards changes in China, comparing the effects of new IFRS-converged Chinese standards on firms required to adopt them from 2007 with firms required to adopt them before 2007. The authors find an increase in the value relevance of the reported earnings of the 2007 adopters, which suggests an improvement in accounting quality. They also find that:

'the increase in the value relevance of reported earnings under the IFRS-converged CAS [Chinese Accounting Standards] is significantly less pronounced among listed firms under the control of the Chinese central government.' The authors point out that: 'This is consistent with the hypothesis that such firms are less motivated to improve financial reporting quality ... as a result of less reliance on external capital because of the financial support they enjoy from government.'

Insider and outsider economies

Ball et al (2000) look at the effect of institutional factors on accounting earnings in different countries. Their sample covers the period 1985-1995 for firms from seven countries: Australia, Canada, the UK and the US (common law countries) and France, Germany and Japan (code law countries). They also have a secondary sample of firms from another eight common law countries and another ten code law countries. The authors find that 'code-law income is substantially less timely and less conservative than common-law income'. They attribute these findings to institutional differences between the two groups of countries.

They argue that in code law countries:

'Governments establish and enforce national accounting standards, typically with representation from major political groups such as labor unions, banks and business associations. At the firm level, politicization typically leads to a "stakeholder" governance model, involving agents for major groups contracting with the firm. Current-period accounting income then tends to be viewed as the pie to be divided among groups, as dividends to shareholders, taxes to governments, and bonuses to managers and perhaps also to employees. Compared to common-law countries, the demand for accounting income under code law is influenced more by the payout preferences of agents for labor, capital and government, and less by the demand for public disclosure. Conversely, because agents for these groups are represented in corporate governance, insider communication solves the information asymmetry between managers and stakeholders. We hypothesize that their preferences penalize volatility in payouts and thus in income.'

On the other hand:

'Under the "shareholder" governance model that is typical of common law countries, shareholders alone elect members of the governing board, payouts are less closely linked to current-period accounting income, and public disclosure is a more likely solution for the information asymmetry problem. In comparison with the more political process in code law countries, the desirable properties of accounting income in common law countries are determined primarily in the disclosure market. We hypothesize those properties include timeliness in incorporating negative economic income (ie, asymmetric conservatism).'

The authors argue that it should not be assumed that, because of the lack of public disclosure, stock market prices fail to reflect all the available information:

‘the flow of information into stock prices is not necessarily impeded in code-law countries by poor public disclosure, but occurs instead via the trading of informed insiders. In the absence of insider-trading laws, which are fundamentally incompatible with code-law governance, corporate insiders’ incentives are to trade on information and thereby incorporate it into prices.’

Consistent with their hypotheses, the authors find that ‘common-law accounting income does indeed exhibit significantly greater timeliness than code-law accounting income, but ... this is due entirely to greater sensitivity to economic losses (income conservatism).’

Ball et al (2003) look at the relationship between accounting standards, incentives and financial reporting outcomes in Hong Kong, Malaysia, Singapore and Thailand over the period 1984–1996. They identify these four countries as ones where, given the influences on their accounting standards (particularly from International Accounting Standards), high levels of transparency might be expected. They find that, interpreting transparency as ‘timely incorporation of economic income in accounting income’, ‘reported earnings in these countries generally lack transparency’. They argue that this is because of reduced market demand for accounting information; in these countries, ‘Public debt and equity finance tend to be replaced by family ownership and private banking relationships, thereby reducing the demand for timely public disclosure.’ Managers therefore lack the incentives to produce transparent financial reporting information.

Holthausen (2003) is a commentary on Ball et al (2003). Among other things, the author argues the following:

- International Accounting Standards during the period under review, 1984–1996, may not have been high-quality standards. They became of higher quality subsequently.
- It should not be assumed that US levels of timely loss recognition indicate the appropriate levels for high-quality accounting in other countries. The level of timely loss recognition in the US, ‘likely affected by the extensive litigation environment’, may not be appropriate for countries with different institutional settings. In any case, different users probably have different preferences regarding the level of timely loss recognition.

On this second point, **Ball and Shivakumar (2005)**, which we refer to in **Private companies** (see page 21), are explicit that a lower quality outcome may be optimal. Holthausen (2003) also notes that:

‘While it is undoubtedly safe to say that the outcome of [the] financial reporting process responds to incentives, institutions and accounting standards, it is much more difficult to say what outcomes are high quality and what outcomes are low quality.’

Further:

‘it may be possible to undo or mitigate the effects of incentives and other forces, conditional on having adequate standards to begin with. If so, standards could still play a pivotal role in economies like those studied [in **Ball et al (2003)**], even if, on average, the institutions don’t support them. As such, it would be premature to assume that adopting high quality standards could not lead to better outcomes for those firms which would like to opt out of a generally low quality environment.’

Leuz et al (2003) look at earnings management in 31 countries for 1990–1999. They classify the countries into three groups:

- ‘outsider economies with large stock markets, dispersed ownership, strong investor rights and legal enforcement (eg, UK and US);
- ‘insider economies with less developed stock markets, concentrated ownership, weak investor rights, but strong legal enforcement (eg, Germany and Sweden); and
- ‘insider economies with weak legal enforcement (eg, Italy and India)’.

The authors find that ‘outsider economies with relatively dispersed ownership, strong investor protection and large stock markets exhibit lower levels of earnings management than insider countries with relatively concentrated ownership, weak investor protection and less developed stock markets.’

Auditing

As indicated above, **Ali and Hwang (2000)** find that value relevance of financial reports is lower in countries where spending on audit services is relatively low.

Chen et al (2002) provide negative evidence on the effects of auditing. They look at the effects of Chinese harmonisation of local GAAP with International Accounting Standards (IAS). Chinese companies with B shares can issue them to foreigners. These companies, which prepare their accounts in accordance with Chinese GAAP, formerly also had to publish their earnings calculated in accordance with IAS. With effect from 1998, the Chinese government issued revised accounting standards, which removed most of the previous differences with IAS. Looking at a sample of Chinese firms with B shares for the period 1997–1999, the authors ‘find no evidence that the Chinese government’s efforts eliminated or significantly reduced the gap between Chinese [GAAP] and IAS earnings’. They also find that **‘a lack of supporting infrastructure, manifested in excessive earnings management and low quality auditing, may explain the gap’**.

Francis et al (2003) also consider the effects of a number of different institutional factors, including auditing. They look at data from 31 countries. They find that:

‘financial disclosures are more transparent and national accounting standards require timelier ... reporting in countries with stronger investor protection. These countries also spend more on auditing enforcement and the Big Five accounting firms audit proportionately more companies in these countries.’

The literature on the effects of auditing on financial reporting, including references to a number of other papers, is reviewed in **Dechow et al (2010)**, section 5.4, and **Walker (2013)**, section 8.3. **Dechow et al (2010)** note that ‘With few exceptions, studies suggest that firms with Big-X auditors have significantly lower discretionary accruals than firms with non-Big-X auditors’, but that ‘the voluminous evidence on the relation between audit fees and accruals quality is mixed’. One difficulty in judging the effects of auditing on financial reporting is that the quality of auditing is unobservable by researchers and so they use proxies for it.

Corporate governance

The literature on the effects of corporate governance on accounting is reviewed in **Dechow et al (2010)**, section 5.3, **Brown et al (2011)**, section 6, and **Walker (2013)**, section 8.1.

Dechow et al (2010) conclude that ‘evidence on governance mechanisms other than internal control procedures is weak or mixed’.

Brown et al (2011) report that ‘the evidence provides a mixed view on whether better [corporate governance] has a positive influence on disclosures’. On conservatism, they conclude that ‘the relationship between [corporate governance] and conservatism remains uncertain’ and note that many studies on this question ‘do not control for the potential endogenous nature of accounting choice and [corporate governance] structures’. On earnings management, they conclude that the research evidence ‘confirms firms with better [corporate governance] are typically subject to less earnings management’.

Walker (2013) notes that a number of papers ‘tend to find that the incidence of [earnings management] is negatively related to the quality of corporate governance’, but points out that governance structure, like earnings management, is chosen by the firm. In other words, it may be that the sort of firm that chooses to have high-quality corporate governance also chooses to eschew earnings management. In which case, finding a correlation between the two does not necessarily indicate that corporate governance is constraining earnings management. This is the endogeneity problem identified by **Brown et al (2011)** in relation to conservatism.

As with auditing, a difficulty in judging the effects of corporate governance on financial reporting is that the quality of corporate governance is unobservable by researchers and so they have to use proxies for it.

Enforcement

Bushman and Piotroski (2006) look at data from 38 countries for the period 1992–2001 to assess the effects of different institutional arrangements on financial reporting conservatism. They find that:

‘firms in countries with strong judicial systems reflect bad news in earnings faster than firms in countries with weak judicial systems... [H]igher judicial quality and higher usage of public bonds or more diffuse ownership structures leads to more conservatism. Also, strong public enforcement aspects of securities law (but not private enforcement) slow recognition of good news in earnings relative to firms in countries with weak public enforcement.’

They also find that:

‘firms in countries with common law legal origin combined with high risk of expropriation by the state and high state ownership of enterprises speed the recognition of good news and slow the recognition of bad news relative to firms in countries with less political involvement. This result is reversed in countries with civil law legal origin and high risk of expropriation and high state ownership of enterprises.’

Daske et al (2008) look at evidence from 26 countries where there was mandatory IFRS adoption. The sample covers 2001–2005.

The authors find an increase in the cost of equity capital in the year of IFRS adoption for mandatory adopters, but also find that ‘the cost of capital decreases by 26 basis points ... when we measure the effect one year before the mandatory adoption date’. They also look at changes in Tobin’s Q^2 , but find that they are insignificant for mandatory adopters. However, Tobin’s Q ‘increases by 7% when we measure the effect one year before the mandatory adoption date’.

The authors find that the capital market benefits they detect ‘occur only in countries where firms have incentives to be transparent and where legal enforcement is strong’, though this finding is less significant for the cost of capital than for liquidity (see below). They also comment that, ‘As several countries around the world revise their enforcement and governance regimes to support the introduction of IFRS, we suggest that our results likely reflect the joint effects of these institutional changes and the IFRS mandate.’

Lee et al (2008) look at the effects of mandatory IFRS adoption on the cost of equity capital in 17 European countries. The period covered is 1995–2006. The countries in the sample are classified into those with a higher- or lower-quality financial reporting environment and enforcement. This is based on five criteria: outsider rights; the importance of the equity market; ownership concentration; disclosure quality; and earnings management. On this basis, the UK, for example, scores five, France and Spain score one, and Germany and Italy score zero.

The authors report that ‘we find no evidence of a reduction in the cost of equity capital among countries where there are relatively low financial reporting incentives and enforcement. Instead, we find a significant reduction in the high incentive group, mainly companies based in the UK.’

Li (2010) looks at changes in the cost of equity capital in 18 EU countries following mandatory IFRS adoption. The sample covers the period 1995–2006. The author finds that mandatory adopters in strong legal enforcement countries experience a cost of capital reduction of 91 basis points, whereas mandatory adopters in poor legal enforcement countries (which include France and Germany) ‘experience no significant change in the cost of equity capital after 2005’. The author warns that, ‘as EU countries have been making continuous efforts to strengthen their legal and enforcement systems ...’, the finding of a reduced cost of equity might be a joint outcome of IFRS adoption and concurrent events such as recent institutional improvements.’

Capital market liquidity is often taken to be evidence of financial reporting transparency. The more transparent the reporting, the greater the liquidity. **Daske et al (2008)**, referred to above in relation to the cost of equity capital, also look at the effects of mandatory IFRS adoption on liquidity. They find for mandatory IFRS adopters liquidity increases, for example, 6% for bid-ask spreads (ie, 6% reductions in bid-ask spreads). However, they find that the liquidity benefit (like the cost of capital benefit) occurs ‘only in countries where firms have incentives to be transparent and where legal enforcement is strong’. The authors’ comment, noted earlier, that their findings probably reflect enforcement and governance changes as well as the introduction of IFRS, also applies to their findings on liquidity.

Improvements in transparency and international comparability may lead to increased cross-border investment. **Florou and Pope (2012)** look at the effects of mandatory IFRS adoption on the international holdings of institutional investors. The test sample of mandatory adopters comprises firms from 24 countries and there is a control sample of non-adopters from 21 countries, mostly from the US and Japan. The period covered is 2003–2006. The authors find that, ‘after controlling for standard economic determinants of institutional holdings, ... over the two-year period 2005–2006 institutional ownership increases by more than 4 percent and the number of institutional investors increases by almost ten [percent] for mandatory IFRS adopters, relative to non-adopters.’ They also find that ‘the positive impact of mandatory IFRS adoption on institutional holdings is restricted to countries where enforcement and reporting incentives are strong and where divergence between local accounting standards and IFRS is relatively high’.

² As used by accounting and finance researchers, the ratio of market capitalisation to net book value.

Christensen et al (2013) look at the liquidity effects of mandatory IFRS adoption, in particular in the EU. Voluntary adopters and non-adopters (mostly from Japan and the US) provide control samples. The study covers the period 2001-2009. Although the focus of the paper is liquidity, this issue is chosen by the authors with the intention of raising broader questions about measuring the capital-market effects of IFRS adoption. They explain their choice as follows: 'We examine market liquidity because it has a clear theoretical link to reporting quality, can be measured over short intervals, and is less anticipatory in nature than other economic constructs like cost of capital.'

The authors conclude that 'the liquidity effects around IFRS introduction are ... limited to [four] EU countries that concurrently made substantive changes in reporting enforcement': namely, Finland, Germany, the Netherlands, and the UK. The authors in fact treat Norway as a fifth EU country in this category, on the grounds that it is a member of the European Economic Area and has adopted the EU capital market directives. For these five countries, the authors find liquidity increases of 'between 18 and 23 percent relative to pre-IFRS liquidity levels'.

They note that:

'It is possible that IFRS reporting was a precondition for the enforcement changes to take place or, alternatively, that the liquidity effects would have been smaller without IFRS adoption. The majority of our tests cannot rule out either possibility. However, the ... sum of our results makes it unlikely that the change in accounting standards is the primary or even an important driver of the liquidity effects around IFRS adoption.'

The accuracy and dispersion of investment analysts' forecasts can be regarded as measures of financial reporting transparency. The more transparent the reporting, the more accurate and less dispersed the forecasts should be. **Preiato et al (2015)** look at the accuracy and dispersion of analysts' forecasts for mandatory IFRS firms, voluntary IFRS firms and non-IFRS firms in 39 countries for 2003–2009. To help analyse the results they construct indices for auditing and for accounting enforcement for 2002, 2005 and 2008. Of the 39 countries in the sample, 23 are countries where IFRS was made mandatory.

The authors find 'little evidence that mandatory ... use of IFRS per se is accompanied by improvements in the information environment leading to lower error or less dispersion in analysts' forecasts, once we control for the degree of enforcement'. They note that this is contrary to the findings of other studies and they suggest that 'A possible explanation for our contrary results is that other studies have often focused on EU countries and the immediate post adoption period. In contrast, we include a longer time period ..., and we explicitly allow for variation in degree of enforcement.'

There is further discussion of these last two papers in **ICAEW (2015)**, *The effects of mandatory IFRS adoption in the EU*, at panels 3.14 and 6.5 and section 6.2.2.

Equity market transactions

Teoh et al (1998) look at discretionary accruals reported by a sample of US firms making seasoned equity offerings between 1976–1989. They 'document that discretionary current accruals grow before the offering, peak in the offering year, and decline thereafter'.

Botsari and Meeks (2008), looking at a sample of UK firms between 1997–2001, find 'evidence consistent with earnings management ahead of share-financed bids'.

The literature on the effects on financial reporting of equity market transactions such as capital raising and takeovers, including references to a number of other papers, is reviewed in **Dechow et al (2010)**, section 5.5.1 and **Walker (2013)**, section 6.3.

Private companies

Private companies and listed companies face different incentives to provide high-quality financial reporting information. This results in different financial reporting outcomes even when private and listed firms are subject to the same requirements. **Ball and Shivakumar (2005)** compare one attribute of the earnings quality of UK private companies and listed companies for a sample covering the period 1990–2000. The attribute they look at is timely loss recognition, which they find is 'substantially less prevalent in private companies than in public companies, despite the groups facing equivalent regulatory rules.'

Although this suggests that private company financial reporting is of lower quality, the authors emphasise that 'Lower quality does not imply sub-optimality because it can arise from either lower demand for or higher cost of supplying quality. Our findings thus should not be

interpreted as supporting stricter regulation of financial reporting by private firms. Quite the contrary: our hypothesis is that lower earnings quality in private firms is an optimal outcome in the market for financial reporting'. This is because private companies 'are less likely to use public financial statements in contracting with lenders, managers and other parties, and in primary and secondary equity transactions... These differences imply a demand for lower quality financial reporting.'

Burgstahler et al (2006) compare levels of earnings management in private and listed companies from 13 EU countries for a sample covering the period 1997–2003. They find that private firms 'exhibit higher levels of earnings management'.

Peek et al (2010), using data from 13 European countries for the period 1993–2000, find that listed firms show more asymmetric timeliness of gain and loss recognition than private firms. They find that this is due to the demands of creditors of listed firms. They argue that this reflects the relatively greater dependence of lenders to listed firms on public financial reporting information as opposed to private, relationship-based information. The strength of creditor demand in a country is measured by the strength of the protection the country provides for creditors.

We discuss further evidence on variations in financial reporting quality related to public/private status and firm size in the appendix to **ICAEW (2015)**, *SME accounting requirements*.

Institutions

Institutions in 'new institutional economics'

Interest in the role of institutions has grown among accounting researchers in recent decades, partly reflecting growing interest in institutions among economists. Although 'new institutional economics' has been highly influential, the concept of an 'institution' is vague and shifting; different researchers mean different things by it, and sometimes the same researcher means different things by it at different times.

One of the pioneers of this approach to economics has been the economic historian Douglass North. **North and Thomas (1973)** discuss the role of institutions in the long-term economic success of western society. They refer (pp5–6) to the importance of 'institutional arrangements', among which they include: joint stock companies, corporations, bills of exchange, the abolition of serfdom, and insurance companies.

North (1981) states (pp201–202) that:

'Institutions provide the framework within which human beings interact... Institutions are a set of rules, compliance procedures, and moral and ethical norms designed to constrain the behavior of individuals in the interests of maximising the wealth or utility of principals.'

North does not argue that institutions are always efficient. On the contrary, they are usually designed to serve the interests of the ruler or the ruling group, not economic growth for society as a whole: eg, 'Even the most casual observations from history and the contemporary world make clear that "inefficient" property rights are the rule, not the exception' (p28).

North (1990) argues (p137) that 'Institutions determine the performance of economies' and states (pp3-4) that:

'Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.' They include both 'formal constraints – such as rules ... – and informal constraints – such as conventions and codes of behavior.'

This is a formulation very similar to North (1981), but without the focus on the principals' interests.

North (2005) argues (p59) that 'institutional change [is] overwhelmingly incremental and path dependent'. Although 'the sources of productivity growth are well known', you must 'have an intimate understanding of the individual characteristics of [a] society before you are ready to try to change it' (p165). This seems to imply that, although the ideal arrangements for any society (at least as regards productivity growth) might in the long run be similar, shorter-term changes in the direction of this common goal are likely to vary from one society to another, reflecting their existing arrangements.

North et al (2009) state (p15) that 'Institutions include formal rules, written laws, formal social conventions, informal norms of behavior, and shared beliefs about the world, as well

as the means of enforcement.’ They mention elections as an example of an institution. This description is similar to **North (1981)** and **North (1990)**, but with the major addition of beliefs.

North et al (2009) also refer (p115) to ‘institutional elements’ and give as examples:

- ‘open access for organizations of all types’;
- ‘market economies’; and
- ‘competitive elections’.

Another pioneer of new institutional economics is Oliver Williamson. **Williamson (1985)** argues (p1) that ‘the economic institutions of capitalism ... have the main purpose and effect of economizing on transaction costs.’ They are, he explains (p2), ‘numerous, subtle, and continuously evolving’. The full title of the book – *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* – indicates that the author takes a broad view of what an institution is. His view of the firm (considered in the abstract³) as an institution is consistent with **North and Thomas (1973)**’s view that corporations are an institutional arrangement. The idea that markets are institutions also seems to be consistent with the way that North describes institutions, institutional arrangements and institutional elements. ‘Relational contracting’ requires some explanation.

Williamson (1985) argues that ‘the governance of contractual relations is primarily effected through the institutions of private ordering rather than through legal centralism’ (pxii) or, put another way, ‘contractual disputes and ambiguities are more often settled by private ordering than by appeal to the courts’ (p10). By private ordering he means negotiation or alternative dispute resolution techniques such as arbitration. This form of settling problems between firms is what Williamson means by ‘relational contracting’. The argument is that both parties to the contract (which may not even exist in a formal sense) have an interest in maintaining a relationship. Where difficulties arise the parties therefore have an incentive to settle them in a low-cost way that preserves the relationship. Going to court does not provide such a method. Williamson argues that such relational contracting typically develops for ‘transactions of a recurring and nonstandardized kind’ (p73).

An institution in this sense is simply a way of doing things. It may be what North refers to as a ‘norm’, but it is a norm that could evolve in specific ways for particular relationships; it is not necessarily a society-wide norm. Indeed, as firms have their own particular ways of doing things within the firm, such internal conventions and procedures could reasonably be regarded as entity-specific institutions. However, the usual way in which institutions are thought of in economics is as society-wide phenomena that vary among jurisdictions.

The discussions in North, Williamson and other pioneers of new institutional economics are qualitative, but researchers have made institutional economics quantitative by quantifying different countries’ institutional arrangements. The pioneering work in this field is a series of papers by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer and Robert W. Vishny, including **La Porta et al (1997)**, **La Porta et al (1998)**, **La Porta et al (1999)** and **La Porta et al (2000)**. These papers provide interesting insights into the relationships between institutions in different countries; eg, they find correlations between ‘differences among countries in ownership concentration in publicly traded firms, in the breadth and depth of capital markets, in dividend policies, and in the access of firms to external finance’ on the one hand and differences in ‘how well investors, both shareholders and creditors, are protected by law from expropriation by the managers and controlling shareholders of firms’ on the other hand (La Porta et al (2000)).

Such findings are in themselves relevant to accounting research; more than that, the La Porta et al papers have provided accounting researchers with valuable databases quantifying countries’ institutional arrangements that the researchers can then use in looking for correlations in their own data. As time passes, more up to date data from other sources have increasingly been used, but the La Porta et al papers helped instigate a new style of accounting research and their data are still referred to.

Holderness (2016) challenges the findings of La Porta et al (1998) by analysing the data differently. La Porta et al (1998) find that ‘concentration of ownership in shares in the largest public companies is negatively related to investor protections’. This is based on a survey of legal protections and ownership in 45 countries and, for each country, on the extent of ownership by the top three shareholders of the ten most highly-valued companies on the local stockmarket.⁴

³ Actual firms, as we note in the main report, are organisations rather than institutions.

⁴ For other purposes the paper looks at 49 countries. For some countries the relevant information was available for fewer than 10 companies. Certain categories of company – banks and insurers, foreign companies, and companies with government shareholdings – were excluded from the sample.

The data are then analysed at the **country** level. By analysing data at the **firm** level, Holderness (2016) finds that 'the ... hypothesis that legal protection and ownership concentration are unrelated at conventional statistical significance levels' cannot be rejected.

As Holderness (2016) points out, 'the basic point of [the] paper goes beyond the ownership-concentration literature' as it casts doubt on the use of country-level averages when firm-level data are available, a point that may be relevant for a number of finance and accounting research papers looking at institutional effects.

Institutions in accounting research

We have seen that economists use the concept of institution in a very broad sense and in different ways at different times. Accounting researchers have followed their example, and use the term 'institution' in at least four different ways: to refer to organisations, to rules and their enforcement, to mechanisms that facilitate economic transactions, and to a wide range of environmental factors relevant to accounting. The different meanings overlap, and it is sometimes unclear which meaning an author has in mind.

- Financial services organisations, such as banks, insurers, and investment funds, are commonly called institutions. This meaning of the word is usually clear enough, although it is sometimes unclear when researchers talk about financing arrangements whether they are using the word 'institutional' to refer to relevant organisations or to something else.
- The idea of institutions as rules (formal and informal) and mechanisms for their enforcement is common in accounting research.
- Institutions as 'mechanisms that facilitate efficient exchanges and interactions between economic players' (Wyssocki, 2011) is another meaning that comes from economics and is also common in accounting research. Consistent with this definition Wyssocki (2011) treats accounting as an institution.
- Some authors refer to a wide range of environmental factors relevant to accounting as institutions. For example, **Bushman and Smith (2001)** refer to the following as 'institutional characteristics':
 - 'the auditing regime';
 - 'the communication infrastructure';
 - 'analyst following';
 - 'the financial architecture';
 - 'the legal environment (including the existence of laws protecting investors against expropriation by corporate insiders and the enforcement of basic property and contract rights)';
 - 'corporate control mechanisms other than legal protection of investors' rights';
 - 'industry concentration';
 - 'political influence over business activities (including the ability and propensity of wealth expropriation from firms through the political process)'; and
 - 'human capital'.

This last, very broad meaning of 'institutions' to some extent matches what **Ball (2001)** describes as the 'infrastructure' of financial reporting. Ball (2001) argues that 'an economically efficient public financial reporting and disclosure system requires the following infrastructure':

- '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'.

Institutional interdependence

Institutions influence one another's development and so tend to develop as clusters of complementary institutions. This makes it difficult to disentangle the effects of any single institution, which is a problem both in designing institutions and in conducting research.

Leuz and Wysocki (2008), for example, note that there are 'significant complementarities between the elements of a country's institutional infrastructure' and point out that 'such complementarities imply that changing one element of the institutional structure independently of the other elements is unlikely to yield desired outcomes'. **Leuz (2010)** illustrates the point, referring to 'interdependencies between reporting rules and enforcement':

'As a result, reporting rules cannot be designed without considering enforcement, and vice versa. For instance, it is possible that a particular rule gives too much discretion to management and, as a result, makes the enforcement of the rule impossible or very costly.'

Similarly, **Leuz (2010)** argues that simply adopting a common set of international accounting standards is unlikely to result in convergence of reporting practices 'unless countries also converge along other institutional dimensions'.

As noted above, the interdependence of institutions poses problems for researchers as well as for policy makers. The point is made by **Holthausen (2009)**, in the context of a discussion on enforcement:

'it is not obvious that in crosscountry studies we can disentangle the effects of enforcement from those of all the other institutions, regulations, and incentives within a country. Many institutions that are created within a country are complementary, designed with respect to the underlying economies and with respect to each other. So while enforcement is undoubtedly important, countries with strong enforcement are likely to have regulations that are more stringent than countries with weak enforcement. Thus, international studies that attempt to try to disentangle the effects of complementary institutions, incentives, and ownership structures are not likely to be very convincing.'

Holthausen (2009) also points out the importance of 'measuring' institutions in research, and the difficulties of doing so. For example, requirements may be taken at face value by researchers but not enforced, and the nature of requirements can change in ways that researchers will not necessarily pick up – eg, if the courts' interpretation of the requirements changes.

Wysocki (2011) also discusses the difficulties that institutional interdependence poses for researchers, noting that 'It is difficult, if not impossible, to attribute observed differences in accounting and economic outcomes across countries exclusively to certain institutions or factors.' He suggests structural equation modelling (SEM) as a technique that may help address such problems.

National accounting systems: classification

There is an extensive literature examining the nature of and reasons for differences in countries' financial reporting regimes and classifying country regimes into different groups. **Nobes (1998)** reviews the literature and identifies 17 institutional reasons that have been proposed to explain international accounting differences:

- nature of business ownership and financing system;
- colonial inheritance;
- invasions;
- taxation;
- inflation;
- level of education;
- age and size of accountancy profession;
- stage of economic development;
- legal systems;
- culture;
- history;

- geography;
- language;
- influence of theory;
- political systems, social climate;
- religion; and
- accidents.

The author argues that it is accounting systems rather than countries that should be classified; firms in the same country may use different accounting systems. He suggests that the two key variables are the strength of equity markets (with outsider finance) and the degree of cultural self-sufficiency.

These are variables that operate mainly at the country level. However, the author observes that in a country whose accounting system reflects weak equity markets, it may happen that, for example, some companies become interested in attracting overseas equity capital, in which case they may adopt an accounting system more characteristic of a country with a strong equity market.

Countries that are culturally self-sufficient will adopt the type of accounting system appropriate to the strength of their equity market. Countries that are culturally dominated by another country – eg, former colonies – tend to adopt the type of accounting system used by the dominant country, but are likely to change their accounting system appropriately if a strong equity market develops.

Sellhorn and Gornik-Tomaszewski (2006), looking at implementation of the EU's IAS Regulation in the various EU member states, find evidence consistent with **Nobes (1998)**.

Nobes (2011) provides evidence that prior differences in accounting systems survive mandatory IFRS adoption, which might be expected if, when accounting standards change, incentives and other institutions do not. Other papers relevant to this point are discussed in section 3.1 of **ICAEW (2015)**, *The effects of mandatory IFRS adoption in the EU*.

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