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Financial Reporting in Emerging Capital Markets: Characteristics and Policy Issues

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SYNOPSIS: The Institute of International Finance, a Washington-based research group, estimates that the flows of private capital into the world's emerging economies will reach $231 billion in 1997. This figure does not include the flows of official capital to these countries, such as loans from the World Bank and the Asian Development Bank. For a group of countries whose political and economic importance has grown dramatically over the past two decades, relatively little has been written about financial reporting in these emerging economies. In this study, we analyze the characteristics of financial reporting in "Emerging Capital Markets" (ECMs). ECMs refer to markets for long-term corporate securities in less-developed and transitional economies. Financial reporting has been increasingly viewed as a vital infrastructure for the growth of emerging markets. As such, increasing attention must be devoted to how the quality of financial reporting in these markets could be enhanced. We suggest that information availability, reliability and comparability provide useful criteria for evaluating and comparing the state of financial reporting in ECMs. Analysis revealed significant financial reporting diversity in ECMs with respect to these three criteria. Subsequent discussion of the regulatory options available to these markets also highlight the complexity and multifaceted nature of the relevant policy issues. We conclude by identifying areas of policy research in regard to financial reporting in ECMs. These research issues include the merits of alternative approaches to accounting regulation and the value of achieving international comparability of financial reporting in those markets.

Data Availability: Data used in this study are available from public sources.

INTRODUCTION

From the perspective of sophisticated investors, the globalization of financial markets has been synonymous with obtaining rapid access to portfolio investment opportunities anywhere in the world, including those in places once regarded as "exotic" or "remote."[1] The 1990s can be regarded as the decade when these "exotic" financial markets, more popularly known as "Emerging Capital Markets" (ECMs), captured the interest of investors worldwide with their promise of offering substantially higher returns compared to the more developed financial markets (Hilton 1994; Price 1994).

The statistics below summarize the phenomenal growth of emerging capital markets

[1] The descriptions "exotic" and "remote" do not imply only geographical distance. These descriptions comprise a bundle of characteristics associated with emerging markets such as small market capitalization, low liquidity, high volatility of returns, limited *(Continued on next page)*

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over a relatively short period of time.[2] Consider the following:

- the market capitalization of ECMs increased fivefold from $319 billion in 1988 to $1.6 trillion in 1993;
- their share of world stock market capitalization increased during the same period from less than 5 percent to 12 percent;
- trading in ECM securities increased six fold from $165 billion to about $1.1 trillion in that period;
- some ECMs registered superb returns on investment, in some cases exceeding 100 percent of the U.S. dollar equivalent index value in just one year.

But these opportunities come at a cost. Despite their potential for significantly higher gains, investments in ECMs are also prone to greater volatility. The possibility of incurring an investment loss is generally much higher in these markets. The risks of investing in ECMs are not associated with only structural, political or economic problems, although admittedly these factors are important (Claessens et al. 1995; Harvey 1995).[3] Equally important are informational problems stemming from the difficulty of obtaining adequate and reliable information useful for evaluating investment opportunities in these markets. As part of the information generating capacity of ECMs, financial reporting is a crucial element in sustaining investor confidence in these markets. The quality of corporate financial reporting in ECMs varies considerably, however, and it has increasingly been difficult to ignore the impact of poor financial reporting on the performance of these markets.

In this study we analyze financial reporting issues that are particularly relevant to ECMs. We discuss the relationship between features of financial reporting and the development of emerging capital markets. These linkages are examined from a policy perspective. Attention is drawn to the choices facing emerging markets in regard to improving their financial reporting systems. By drawing attention to issues pertinent to developing economies, we attempt to partially redress the paucity of research into ECMs. In particular, research in this area is at a tentative stage and, from a policy viewpoint, an urgent need exists for inquiry into the potential contribution of financial reporting to the development of emerging and transitional economies.

The remainder of this study is organized as follows. Section 2 provides an overview of ECMs and why these markets are important to developing countries in general. In section 3, we discuss briefly the evidence supporting the role of financial reporting in ECMs. In section 4, we define three criteria related to financial reporting by which ECMs can be analyzed and compared. These criteria provide an organizing framework for discussing policy options available to ECMs in section 5. Finally, section 6 concludes our discussion and suggests areas for further research.

THE NATURE AND IMPORTANCE OF EMERGING CAPITAL MARKETS

The crucial role of financial reporting in ECMs can be located more broadly within the policy context of capital market development in less-developed countries (LDCs). Currently, an "Emerging Capital Market" is understood to mean a stock market located in a developing country.[4] At present there are 47 countries whose capital markets that are considered ECMs by the International

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Footnote 1 *(Continued)*
number of premium-grade and investment-grade securities and a lack of well-developed domestic institutional investor base. See Calderon-Rossell (1990), Price (1994) and Harvey (1995) for a discussion of these characteristics.

[2] Compiled from IFC (1994).

[3] Structural problems of ECMs include the small size of their market capitalization, low liquidity and limited investment choices. Political and economic problems are associated with political risk and uncertainty, macroeconomic stability (e.g., Mexico's recent economic crisis) and the possibility of unfavorable government regulations affecting capital market investments.

[4] The World Bank (1994) defined a "developing country" as one whose average income per capita does not exceed a certain level established by the bank. In 1993, the cut-off was set at $8,000.

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Finance Corporation (IFC 1994), the World Bank's investment arm (table 1).

The capital markets classified as "emerging" are quite diverse in terms of their size and history. Some ECMs such as those in Korea, Malaysia, Mexico, and South Africa are quite large in terms of market capitalization which, in some cases, approaches or even exceeds the market capitalization of shares traded on the stock exchanges of some developed countries. Moreover, some emerging capital markets, such as those in India, Malaysia, South Africa and Zimbabwe, have existed since these countries' colonial eras, whereas others, such as those in Botswana and Ecuador, have been established only in the 1990s (*Economist* 1988; IFC 1994).

For most LDCs, relying on their stock markets as a means of raising large-scale capital is a relatively novel approach to enterprise financing, prompting references to it as a "non-traditional" source of finance to distinguish it from the more "traditional" sources of informal and bank finance (World Bank 1989; IMF 1992). The development of active markets for corporate securities is generally seen as a step upward on the ladder of financial development (Frankel 1993). Multinational lending institutions such as the World Bank, as well as development economists, have generally agreed that a well-functioning stock market provides the impetus necessary for the economic growth of these countries (Van Agtmael 1984; ADB 1986; World Bank 1990; IMF 1994). The benefits of ECMs to developing countries are varied and help to explain the role of financial reporting within these markets.

First, many LDCs suffer from an investment-savings gap. This gap means that funds available fall far short of the amount needed to stimulate economic development. In this regard, ECMs expand the investment options available in the country, which attracts portfolio investments from overseas. Domestic savings are also facilitated by the availability of investment options (Tarumizu 1991).

Moreover, credit allocation in many LDCs has often been made on bases other than economic efficiency. Consequently, available funds could be misallocated into such things as inefficient state monopolies that sap the financial resources available for productive investments elsewhere. ECMs also allow enterprise funds to be raised in a

TABLE 1
Emerging Capital Markets According to Geographical Location

Africa	Botswana, Cote d'Ivoire, Cyprus, Egypt, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa, Swaziland, Trinidad and Tobago, Tunisia, Zimbabwe.
Asia	Bangladesh, China, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Sri Lanka, Taiwan, Thailand.
Europe	Greece, Hungary, Poland, Portugal, Turkey.
Latin America	Argentina, Barbados, Brazil, Chile, Colombia, Costa Rica, Ecuador, Jamaica, Mexico, Panama, Peru, Uruguay, Venezuela.
Middle East	Iran, Jordan, Morocco, Oman.

Source: IFC (1994).

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more cost-effective manner (Glen and Pinto 1995). For example, the amount of new capital raised by developing countries rose from virtually zero in 1987 to over $5 billion in 1991, representing about 10 percent of the total capital raised by LDCs in 1991 (IMF 1994).

ECMs can also influence positively the "economic culture" existing in LDCs. Well-functioning markets allow individuals to have a stake in enterprises in their respective countries and help to change cultural attitudes with respect to participating in economic development activities and monitoring the socio-economic contributions of enterprises. In turn, domestic enterprises are encouraged to become more responsive and accountable to a greater number of stakeholders in society (ADB 1986). These changes are particularly important in the transitional economies, i.e., countries attempting to reform the basis of their economic system from that of relying on state central planning to the free operation of markets (Malle 1994).

Finally, ECMs assist in developing further information flows, a prerequisite for enhancing the allocative efficiency of the economy. By providing market-based signals, ECMs assist in channeling funds to the most efficient and productive enterprises. Also, active stock markets serve as a barometer for a country's economic health by signaling expectations regarding macroeconomic variables such as economic growth and inflation. In this role, ECMs provide important information for government macroeconomic planning (ADB 1995).

THE ROLE OF FINANCIAL REPORTING IN EMERGING CAPITAL MARKETS

Before ECMs can fulfill their developmental roles, it is essential to have in place a set of corporate reporting policies and procedures geared toward supplying the information necessary for making investment decisions. This view is well-recognized by multilateral lending institutions that support the strengthening of the accounting infrastructure in ECMs (ADB 1986, 1995; World Bank 1989, 1990). In its report on capital market developments in the Asia-Pacific region, the ADB (1995, 229) stressed that "accounting information is an essential element of infrastructure for a financial system." The World Bank (1989, 90), in turn, observed that "in developing countries, accounting and auditing practices are sometimes weak, and financial laws and regulations do not demand accurate and timely reports. Developing an effective accounting and auditing profession is essential for building efficient financial markets." Moreover, a survey of investment institutions dealing on a regular basis with ECMs showed that the accounting and legal infrastructure underlying an ECM was a major factor for evaluating the investment potential of the market (Van Duyn 1993).

Financial reporting is central to regulations pertinent to establishing an active market for corporate securities. In particular, it is fairly common practice in ECMs to require companies to submit a detailed prospectus of the offer (in compliance with government regulation) and to satisfy the listing requirements of the domestic stock exchange if the company wants its securities to be traded in the exchange. Listing criteria generally consider characteristics such as the company's size (i.e., measured in terms of reported assets, revenues or shareholders' equity), historical performance (i.e., profitability and financial stability), and future prospects (*Economist* 1988). One of the main policy aims in ECMs is to ensure that only companies that satisfy minimum "quality" requirements are allowed to issue publicly-traded securities. At the same time, governments also want to promote so-called entrepreneurial or start-up ventures, which by their nature are riskier than more established companies (IMF 1992). It is not unusual, therefore, that a tiered system exists in many ECMs with "speculative" securities being traded on a secondary or over-the-counter market while so-called "blue chip" or premium securities are traded in the main stock exchange (*Economist* 1988; Price 1994). Financial reports provide an important basis for formulating an appropriate investment

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portfolio that could include a combination of these "blue chip" and "second-line" companies.

Available evidence tends to bolster further claims that the financial reporting system is a crucial component of the infrastructure for developing domestic capital markets. A significant body of research shows that accounting reports are relevant to investors' buy and sell decisions (Foster 1980; Beaver 1981). The importance of accounting reports for stock market investors has been demonstrated through capital market studies conducted in different countries and cross-country surveys of users (Choi and Levich 1990; Bhushan and Lessard 1992). Lev (1988) attributes the prevalence of accounting regulations worldwide to the need to maintain the informational efficiency of capital markets. The worldwide pre-eminence of U.S. and U.K. capital markets has been associated, in part, with the stringent nature of financial reporting in these countries, which, in turn, resulted in the increased availability of information for decision-making purposes. The relationship between accounting information and the growth of domestic securities markets is a crucial policy issue for LDCs that aim to boost capital inflows to their economies (Ndubizu 1992; Larson 1993). As pointed out by Walter (1993, 15), "the nature and extent of information production and disclosure is central to equity market development and the ability to attract cross-border flows....The stronger and more independent the information infrastructure, the more attractive an emerging market will be to foreign equity investors."

CHARACTERISTICS OF FINANCIAL REPORTING IN EMERGING MARKETS

Recognizing the importance of adequate financial reporting and actually possessing a satisfactory financial reporting regime are two different matters. The pragmatic reality often falls far short of the desired situation in ECMs. In this section, three qualitative criteria for evaluating financial reporting in ECMs are suggested. These criteria are information availability, reliability and comparability. Focusing on these criteria assists in highlighting areas for improvement and policy formulation. While these criteria are qualitative in nature, they provide the focal point for developing benchmarks for comparing and improving the performance of extant financial reporting systems in these markets.

Availability

Availability means that financial and other information on publicly-listed companies is adequate, timely and conveniently accessible. The adequacy of corporate information is linked inextricably to issues of disclosure. There is a perception that disclosure adequacy in ECMs lags behind that in developed capital markets. One method for measuring disclosure adequacy is to rank countries in terms of a specific disclosure index. A recent study that compared financial disclosures of industrial enterprises from 41 developed and emerging stock markets showed that enterprises in ECMs generally provided less disclosures compared to those in developed markets (CIFAR 1995). Table 2 presents the disclosure ranking and scores of selected industrial companies from 20 ECMs relative to companies from 21 developed capital markets.

Among the 21 countries ranked in the top half in terms of disclosures, only six (about 29 percent) were from ECMs (i.e., Malaysia, Singapore, South Africa, Chile, Sri Lanka and Pakistan). In comparison, of the 20 countries in the lower half in terms of disclosure levels 14 (about 70 percent) were from ECMs. Only five developed market countries were in the bottom half in terms of disclosure levels: Austria (18th), Italy (16th), Belgium (14th), Japan (12th) and Spain (11th). The results indicate that a higher proportion of companies in ECMs disclose less financial and other information compared to companies in developed capital markets. A significant degree of variability also exists among ECMs in terms of fundamental accounting disclosures. This variability is illustrated by the diversity in disclosure requirements in 12 selected ECMs.

As shown in Table 3, differences in mandatory disclosures are apparent with respect

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TABLE 2
Disclosure Levels of Industrial Companies in Selected ECMs and Developed Capital Markets

Rank	Country	Average Score	Rank	Country	Average Score
1	United Kingdom	85	11	Spain Zimbabwe*	72
2	Finland Sweden	83	12	Japan Mexico*	71
3	Ireland	81	13	Nigeria*	70
4	Australia New Zealand Switzerland	80	14	Argentina* Belgium South Korea*	68
5	Malaysia* Singapore South Africa*	79	15	Germany	67
6	Chile* France	78	16	Italy Thailand*	66
7	USA	76	17	Philippines*	64
8	Canada Denmark Norway	75	18	Austria	62
9	Israel Netherlands Sri Lanka*	74	19	Greece* India*	61
10	Hong Kong Pakistan*	73	20	Colombia* Taiwan* Turkey*	58

* ECM
Source: CIFAR (1995).

to quarterly financial statements, consolidated and cash flow statements, segment information and inflation adjusted accounts, related party information, extraordinary items, discontinued operations, post-balance sheet events and forecast profits. The only item that is mandatory in all 12 countries is the "notes showing accounting policies." Moreover, no country requires all information suggested in Table 3 to be disclosed. These variations in disclosure regulation suggest that disclosure practices, to the extent that they comply with extant requirements, also differ across ECMs.

In terms of timeliness of financial reporting, ECMs generally impose requirements for listed companies to furnish audited financial statements on an annual basis. As of 1993, only China did not impose this requirement

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TABLE 3
Disclosure Requirements in Selected ECMs*

Panel A:

	Disclosures	ARG	BRA	GRE	IND	KOR	MAL
1	Quarterly financial statements	•					
2	Notes showing accounting policies	•	•	•	•	•	•
3	Consolidated financial statements		•				•
4	Cash flow statements					•	
5	Earnings per share data		•		•	•	•
6	Segment information				•	•	•
7	Inflation-adjusted accounts	•	•				
8	Related party information		•		•	•	•
9	Extraordinary or unusual items	•	•		•	•	•
10	Discontinued operations				•		•
11	Post-balance sheet events	•	•		•		•
12	Forecast profits		•		•		•

Panel B:

	Disclosures	MEX	NIG	PHI	POL	SAF	TAI
1	Quarterly financial statements	•		•		•	•
2	Notes showing accounting policies	•	•	•	•	•	•
3	Consolidated financial statements	•	•	•	•	•	
4	Cash flow statements	•		•	•	•	•
5	Earnings per share data	•	•	•		•	
6	Segment information				•	•	•
7	Inflation-adjusted accounts	•					
8	Related party information	•	•	•	•		
9	Extraordinary or unusual items			•	•	•	•
10	Discontinued operations	•		•	•	•	
11	Post-balance sheet events	•	•		•	•	
12	Forecast profits	•	•			•	

* Disclosure requirements are based on stock exchange requirements and accounting standards in each country as of 1991. Information assembled from various sources including IFC (1994) and Coopers & Lybrand International (1991).

Symbols: ARG (Argentina); BRA (Brazil); GRE (Greece); Ind (Indonesia); KOR (South Korea); MAL (Malaysia); MEX (Mexico); PHI (Philippines); POL (Poland); SAF (South Africa); TAI (Taiwan).

Sources: Authors' survey of stock exchanges; CIFAR (1995).

(IFC 1994). Moreover, most ECMs require either quarterly or semi-annual financial statements to be released. The general trend has been toward quarterly financial reporting. In practice, however, the actual release of the financial statements varies from between two and six months after the end of the financial year (CIFAR 1995).

Capital market research, mostly in developed capital markets, indicates that financial information is released continuously such that little, if any, new information exists when the financial reports are eventually released "officially" (Beaver 1981). Evidence concerning the effects of information release on share market activities in ECMs is quite limited. A major reason for the paucity of capital market-based studies in ECMs is the difficulty of obtaining data regarding the public release of information in

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these markets and share price/volume changes over a sufficiently long period of time. Available evidence on Asia-Pacific ECMs indicates that the notion of semi-strong efficiency, i.e., that publicly available information is immediately reflected in share prices and trading, retains qualified support in these ECMs (Ariff and Johnson 1990; Ghon Rhee et al. 1990). In general, however, these ECMs were less semi-strongly efficient than their developed market counterparts in that it took longer for the "publicly available" information to be impounded in the stock prices. The results suggest that the underlying infrastructure of ECMs is sufficiently different from those in developed markets to affect the efficiency by which information is processed.

Convenient access to financial information is also a key feature of information availability. In the larger and relatively more sophisticated ECMs such as Malaysia and South Africa, real-time information is made available through on-line systems connected to organized securities exchanges. Ready access to such information is viewed as contributing to increased market efficiency and liquidity (Modigliani and Perotti 1991). In other ECMs the public dissemination of information is limited by several factors. One is the absence of an efficient securities exchange agency that co-ordinates the retrieval and dissemination of corporate information. Financial reports may be collated and stored by a central government repository (e.g., Companies Registrar), allowing some form of limited public access to the stored information. Another major inhibiting factor is weakness in the research capability of local brokers and financial institutions. Shortages of qualified personnel, absence of effective competition among brokers, and a weak financial press often combine to retard the flow of financial and other information to investors (Harvey 1995).

Reliability

The second criterion for evaluating financial reporting is *reliability*. Reliability encompasses two requirements. First, financial reports need to be prepared on the basis of sound accounting requirements. Second, adequate steps should be taken to ensure compliance with these accounting requirements. On the one hand, evaluating financial reporting reliability involves examining the basis of account preparation, i.e., accounting standards. In many ECMs, the absence of a strong capability to develop domestic accounting standards means that standards are borrowed from overseas (Samuels and Oliga 1982; Wallace 1993). Some ECMs have attempted to emulate financial requirements in more developed capital markets by adopting International Accounting Standards (IAS). The IAS, in turn, are known to have incorporated accounting methods generally accepted in countries such as the U.K. and U.S., widely considered the leading financial markets in the world (Wallace 1990; Chandler 1992). Table 4 indicates whether, and to what extent, selected ECMs have adopted IAS as a basis for domestic financial reporting.

Table 4 shows that 19 out of the 30 ECMs (63 percent) have either wholly adopted IAS or used IAS to formulate domestic accounting standards. This adoption rate suggests that IAS generally enjoy considerable support in ECMs, perhaps more so than in developed capital markets with resources available to develop their own domestic standards (Nobes 1990). Paradoxically, the board membership of the IAS is dominated largely by representatives from developed capital markets, and only Mexico, among ECMs, is a founding member of the IASC (Wallace 1990; Purvis et al. 1991). Adoption of IAS, however, does not necessarily translate to perceived quality in accounting standards. Table 5 summarizes an IFC classification of ECMs on the basis of the perceived quality of their accounting standards.

A principal source of weakness in domestic accounting standards adopted in ECMs is that extant standards do not address specific areas of accounting that have significant impact on the financial statements. These include areas such as accounting for business combinations, investments, property and equipment, leases, foreign currency

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TABLE 4
Adoption of IAS in Emerging Capital Markets

Wholly or Largely Adopted IAS as Domestic Standards	Used IAS to Formulate Some Domestic Standards	Did Not Adopt IAS
Indonesia	Bangladesh	Argentina
Malaysia	China	Brazil
Pakistan	Colombia	Chile
Singapore*	Hong Kong*	Egypt
Zimbabwe	India	Greece
	Mexico	Hungary
	Nigeria	Jordan
	Peru	Korea
	Philippines	Portugal
	Poland	Turkey
	Sri Lanka	Venezuela
	Taiwan	
	Thailand	
	Uruguay	

Sources: Coopers & Lybrand (1991); Larson (1993).
* Hong Kong and Singapore are not generally considered ECMs but are included here because they exemplify developed capital markets that have only recently emerged as important global financial centers.

TABLE 5
Perceived Quality of Domestic Accounting Standards

Good	Adequate	Poor
Brazil	Argentina	China**
Chile	Colombia**	Indonesia*
Mexico**	Greece	
India**	Hungary	
Korea	Jordan	
Malaysia*	Nigeria**	
Philippines**	Pakistan*	
Sri Lanka**	Peru**	
	Poland**	
	Portugal	
	Taiwan**	
	Thailand**	
	Turkey	
	Venezuela	
	Zimbabwe*	

* Wholly adopted IAS.
** Used IAS as basis for some domestic standards.
Source: IFC (1994).

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transactions and translations, long-term contracts, and financial instruments. The absence of standards in these areas creates significant uncertainty with respect to how particular transactions are to be accounted for in the financial statements. Companies often follow a variety of accounting treatments, some of which are dubious and result in potentially misleading financial statements. For example, the lack of standards on lease accounting and financial instruments affords companies significant scope for engaging in off-balance sheet financing that distorts the actual degree of financial leverage enjoyed by these companies.

Even where adequate financial accounting standards exist, enforcement is a potential problem in many ECMs. The most rigorous requirements mean little if enforcement is inadequate or absent. In ECMs, particular political, economic and socio-cultural factors affect significantly the strength of enforcement (Jaggi 1975; Wallace and Briston 1993). Often, deficiencies in actual enforcement are traceable to a lax attitude toward financial reporting, weaknesses in the administrative mechanisms for enforcing standards, or both. The accounting and auditing profession in some countries may be relatively weak, owing to lack of government support or an inadequate degree of organization. The government agencies charged with monitoring compliance are understaffed or overburdened with other responsibilities.The absence of an effective government (or quasi-government) agency that monitors compliance with pertinent regulations would encourage widespread violations of extant regulations.

With respect to the audit function, substantial differences have been observed in regard to the level of assurance provided by an independent audit in various national settings. These differences are traceable to a variety of factors including the training and qualifications of local auditors, differences in audit standards and requirements, differences in the nature of the audits conducted and in the availability of auditors (Heaston 1984; CIFAR 1995).

Enforcement capability is enhanced by the presence of adequate numbers of qualified auditors and accountants. A principal difficulty in many ECMs, however, is the shortage of qualified auditors capable of attesting to the reliability of financial statements. Table 6 shows the relative proportion of auditors to the general population in selected emerging and developed capital markets.

As a group, ECMs have substantially fewer professional accountants and auditors than developed capital markets. In comparison, the proportions of auditors in important global and regional financial centers such as the U.K., U.S., Singapore and Hong Kong are relatively high. The exception is Japan which has the lowest proportion of auditors to total population among the important global financial centers. Analysis of the Japanese financial systems shows, however, that bank finance continues to dominate the country's financial market, a condition similar to that existing in countries such as Germany and Switzerland. Moreover, compared to other important financial centers, the Tokyo Stock Exchange is relatively more restricted vis-à-vis foreign portfolio investments (Calderon-Rossell 1990; World Bank 1990).

The shortage of qualified auditors in ECMs places a constraint in terms of the ability of these markets to enhance their enforcement capabilities, at least in the short term. The demand for audit services in these countries is expected to increase significantly, however, as ECMs gear up to attract overseas investment inflows. In the long term, countries can seek to address the supply problems by expanding the opportunities for the education and training of auditors. Another potentially important development involves global and regional attempts to liberalize the trade in services under the recent World Trade Organization (WTO). The WTO, which is charged with implementing the provisions of the most recently concluded GATT, is seeking to reduce barriers to the free movement of services, including accounting and auditing services,

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TABLE 6
Accountants and Auditors in Emerging and Developed Markets

Emerging Markets	No. of Auditors Per 100,000 Population	Developed Markets	No. of Auditors Per 100,000 Population
Chile	87	New Zealand	550
Argentina	71	Australia	539
Malaysia	48	U.K.	352
South Africa	35	Canada	350
Philippines	31	Singapore	273
Taiwan	17	Ireland	262
Mexico	15	U.S.	168
Poland	14	Hong Kong	110
Greece	12	Italy	110
Zimbabwe	11	Denmark	106
India	9	Switzerland	53
Sri Lanka	9	Netherlands	52
Nigeria	8	France	45
South Korea	7	Sweden	41
Thailand	5	Belgium	38
Colombia	2	Germany	26
Indonesia	2	Spain	18
Pakistan	2	Finland	10
Brazil	1	Japan	10

Source: Communication with IFAC Secretariat, Aug. 13, 1996.

across countries. To the extent that this is accomplished, supply restrictions in some ECMs could be addressed by transferring accounting expertise from countries with a greater proportion of qualified auditors.

Table 7 reports the results of the evaluation, by CIFAR (1995), of the comprehensiveness of audit reports issued in the 20 ECM countries. Comprehensiveness was defined in terms of the scope of the audit and the amount of information disclosed in the audit reports.

The results show only a few ECMs had comprehensive audit reports comparable to those in more developed markets such as Japan, the U.K. and the U.S. Overall, ECMs had audit reports that were at least as comprehensive as those found in most developed Continental European markets including Belgium, Germany and Luxembourg. These differences in the scope and comprehensiveness of the audit affects the assessment of the reliability of accounts prepared by listed enterprises.

Comparability

The third criterion relates to the *comparability* of financial information. Comparability, in the context of financial reporting, has at least two dimensions. The first dimension of comparability is in terms of the specific accounting policies used to prepare financial reports. International organizations concerned with financial reporting such as the IASC, OECD and UN have asserted that uniform rules for measurement and disclosure are necessary to achieve comparability (IASC 1982; OECD 1986; United Nations 1988). Given the practical difficulties of achieving uniformity in an international setting, these organizations have generally settled for "accounting harmony," which, while not implying total

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TABLE 7
Comprehensiveness of Audit Reports in Emerging Markets

	Above Average	Average	Below Average
Emerging Markets			
	Greece	Argentina	Malaysia
	Korea	Brazil	Nigeria
	Mexico	Chile	Portugal
	Philippines	Colombia	
	Thailand	India	
	Venezuela	Indonesia	
		Pakistan	
		South Africa	
		Sri Lanka	
		Taiwan	
		Turkey	
		Zimbabwe	
Developed Markets			
	Australia	Austria	Sweden
	Canada	Belgium	
	France	Denmark	
	Hong Kong	Finland	
	Israel	Germany	
	Italy	Ireland	
	Japan	Luxembourg	
	Netherlands	New Zealand	
	Spain	Norway	
	Switzerland		
	United Kingdom		
	United States		

Source: CIFAR (1995).

uniformity, means that some degree of consistency and compatibility exists between the rules of countries (Van der Tas 1988; Tay and Parker 1990). Eventually, however, the ultimate goal is to ensure a uniform set of *minimum* standards of disclosure and accounting. The IASC, for example, is engaged in an attempt to trim down the number of accounting options in its standards as a means of obtaining the support of the International Organization of Securities Commissions (IOSCO), the worldwide governmental body of securities regulators (IASC 1989; Purvis et al. 1991; Chandler 1992).

Comparisons between enterprises, particularly those located in different countries, need to account for differences in the bases used for account preparation. These differences in accounting policies do not appear to be a major problem if adequate disclosures allow appropriate restatements to be made. Usually, however, reconciliations between results prepared using domestic standards and those of an alternative basis of accounting, e.g., IAS, are rarely, if ever, provided in local financial statements. Recent studies (Choi and Levich 1990; Bhushan and Lessard 1992) indicate that while international accounting differences are viewed as important by international investors, they are not perceived to be a barrier to international diversification. These studies reveal also that users are able to cope with accounting diversity through gaining insight into the nature and impact of accounting practices in different national settings. The

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findings suggest that knowledge of accounting differences is still a prerequisite for attaining practical comparability between enterprises (Meek and Saudagaran 1990).

To what extent does accounting measurement and valuation diversity exist in ECMs? Prior studies suggest that accounting practices differ significantly worldwide (Meek and Saudagaran 1990). Table 8 provides a summary of accounting methods required or allowed in 12 selected ECMs.

Table 8 indicates that a high degree of accounting diversity (i.e., "accounting disharmony") exists among ECMs. Countries such as Argentina, Brazil, Greece and Mexico, for example, allow or even require financial statements to be prepared using a basis other than historical cost. Argentina and Brazil, in particular, have endorsed the use of constant, rather than nominal, currency values in financial statements to adjust for the persistent inflation experienced in these countries. The ECMs above also allow the upward revaluation of property and equipment, a practice not sanctioned in the U.S. Discretionary and hidden reserves are also tolerated in Greece, Nigeria and Poland, thus increasing the potential that reported results are biased towards greater conservatism (CIFAR 1995).

The second dimension of comparability, often overlooked in the rush to promote accounting harmonization, is the need to understand the contextual significance of financial information. Even if accounting reports are prepared using the same policies, comparability does not exist if the underlying environmental factors which provide significance to the information differ between countries (Cooke and Wallace 1990; Doupnik and Salter 1995). Choi et al. (1983) have aptly drawn attention to this danger of (mis)interpreting accounting numbers apart from the context in which they were derived. Reported profit growth measured in nominal currency, for example, needs to be interpreted cautiously, particularly in ECMs that have experienced significant levels of inflation or currency instability in recent years. The degree of financial leverage, as a measure of investment risk, also needs to take into account the institutional structure of finance in a country (e.g., in some countries, bank finance is organized through conglomerates of related enterprises) and the rate of industrial and economic growth (e.g., the telecommunications sector in many emerging markets is a rapidly growing sector requiring extensive capital investments of firms that wish to tap into the market). A thorough understanding of contextual variables is at least equally, if not more important, than achieving international harmony of accounting rules.

FINANCIAL REPORTING POLICY ISSUES AND OPTIONS IN EMERGING MARKETS

Government policy toward financial reporting represents the cornerstone of improving the quality of financial reporting in ECMs (IMF 1992, 1994; ADB 1995). In this section, we consider briefly three important policy issues facing regulators in ECMs with regard to enhancing their financial reporting capability. These issues are (1) the choice between mandated and voluntary approaches to regulation, (2) approaches to strengthening enforcement capability, and (3) whether, and to what extent, accounting harmonization should be pursued. Our aim here is to identify the policy options available to regulators and circumstances in which each option is likely to be desirable.

It has been recognized generally that financial reporting policy varies among ECMs because of differences in their political, economic and socio-cultural backgrounds (Gray 1988; Cooke and Wallace 1990; Doupnik and Salter 1995). Moreover, factors in each country's national and international environments constrain policy options available to the government. Previous colonial links, for example, appear to influence strongly the choice of an accounting regulatory system. ECMs often share similar financial reporting legislation and practices with the countries by which they were formerly colonized. Conversely, some countries embark on a deliberate approach to reforming their financial reporting systems in response to changes in their

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TABLE 8
Accounting Methods Required or Allowed in Selected ECMs*

Measurements	ARG	BRA	GRE	IND	KOR	MAL
Panel A:						
1. Historical cost is *not* used as an overall valuation method.	•	•	•			
2. Inventory valuation does *not* conform to the lower of cost or market value rule.	•		•			
3. Inventory costing includes the use of Last-in, First-out (LIFO).	•		•			•
4. Marketable securities are *not* valued using lower of cost or market value.	•		•			
5. Equity method is generally *not* used to account for investments in associated companies.		•	•	•	•	
6. Revaluation of fixed assets is allowed.	•	•	•	•	•	•
7. Capitalization of certain leases deemed to be "purchases" is *not* required.	•	•	•			
8. Immediate write-off of goodwill on acquisition is allowed.	•		•			•
9. Adjustment of negative goodwill to stockholders' equity rather than assets is allowed.	•		•		•	
10. Transfer of earnings to legal reserves is required.		•			•	
11. Percentage of completion is *not* required as a basis for revenue. recognition on long-term contracts	•					
12. Deferred taxes are generally *not* recognized.	•		•	•	•	
13. Research and development costs may be capitalized.		•	•	•	•	•
14. Unrealized translation gains and losses on foreign currencies are recognized in income.		•	•	•	•	•
15. Pooling-of-interest method for business combinations is allowed.	•	•	•	•	•	•
16. Discretionary or hidden reserves are allowed.			•			

(*) Account measurement and valuation rules are based on stock exchange requirements and accounting standards in each country as of 1991.

Symbols: ARG (Argentina); BRA (Brazil); GRE (Greece); IND (Indonesia); KOR (South Korea); MAL (Malaysia); MEX (Mexico); PHI (Philippines); POL (Poland); SAF (South Africa); TAI (Taiwan).

(Continued on next page)

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TABLE 8 (Continued)
Accounting Methods Required or Allowed in Selected ECMs*

Measurements	MEX	NIG	PHI	POL	SAF	TAI
Panel B:						
1. Historical cost is *not* used as an overall valuation method.	•					
2. Inventory valuation does *not* conform to the lower of cost or market value rule.						
3. Inventory costing includes the use of Last-in, First-out (LIFO).	•			•	•	•
4. Marketable securities are *not* valued using lower of cost or market value.				•		
5. Equity method is generally *not* used to account for investments in associated companies.		•		•		
6. Revaluation of fixed assets is allowed.	•	•	•	•	•	•
7. Capitalization of certain leases deemed to be "purchases" is *not* required.	•		•			•
8. Immediate write-off of goodwill on acquisition is allowed.		•			•	
9. Adjustment of negative goodwill to stockholders' equity rather than assets is allowed.	•	•			•	•
10. Transfer of earnings to legal reserves is required.	•			•		•
11. Percentage of completion is *not* required as a basis for revenue recognition on long-term contracts.						
12. Deferred taxes are generally *not* recognized.				•	•	•
13. Research and development costs may be capitalized.		•			•	•
14. Unrealized translation gains and losses on foreign currencies are recognized in income.	•	•	•	•	•	•
15. Pooling-of-interest method for business combinations is allowed.		•	•			•
16. Discretionary or hidden reserves are allowed.		•		•		

* Account measurement and valuation rules are based on stock exchange requirements and accounting standards in each country as of 1991.
Symbols: ARG (Argentina); BRA (Brazil); GRE (Greece); IND (Indonesia); KOR (South Korea); MAL (Malaysia); MEX (Mexico); PHI (Philippines); POL (Poland); SAF (South Africa); TAI (Taiwan).

Sources: CIFAR (1995); Coopers & Lybrand (1991); Authors' survey of stock exchanges.

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environments. Recent examples of countries that are contemplating the adoption of "new" accounting systems include China, Poland and Vietnam, countries that are increasingly adopting market-oriented measures in their economies (Jaruga 1993; Tang 1994; Nguyen and Eddie 1995). The search for an appropriate set of financial reporting policies depends on recognizing these differences in the underlying environments of countries.

In view of the diversity of conditions in ECMs, no single set of recommendations would be appropriate or desirable for all of these markets. Nonetheless, by focusing on fundamental issues of information availability, reliability and comparability, regulators will be in a better position to assess the relative merits of alternative policy options available. We assist in this task by discussing the trade-offs associated with these policy options and the conditions likely to make each option appropriate.

Information Availability

Facilitating the availability of financial and other information has not been an easy task in many ECMs. As mentioned earlier, cultural and economic factors often constrain the supply of information in these markets. In general, two policy options have been suggested in regard to increasing the availability of information in these markets. On the one hand, proponents of a "free market approach" suggest that disclosure adequacy is best advanced by allowing enterprises to decide on the appropriate level of disclosure according to their particular circumstances (Foster 1980; Beaver 1981). Competitive market pressures would ensure that the optimal level of disclosure is achieved as firms compete to reduce the costs of obtaining funds from the market. The free market view is supported by studies showing that the level of "voluntary" disclosures of companies increases as they enter competitive financial markets (Choi 1973; Meek and Gray 1989). This option indicates that securities regulators and government economic planners should focus their efforts on encouraging more companies to list in domestic stock exchanges, perhaps using tax and other fiscal incentives, rather than in imposing numerous and costly disclosure standards.

In comparison, advocates of the "mandatory regulatory approach" argue that an adequate framework of disclosure regulation is necessary because of the potential for market failure in the supply of financial information (Bromwich 1985). Where financial information possesses characteristics of a public good, a strong probability exists that such information will be underproduced in the absence of mandatory regulations. Without adequate information, potential investors will be reluctant to participate in the markets that are perceived to be "rigged" in favor of certain vested interests. The perception of unfair securities markets could be aggravated in ECMs where the level of information asymmetry appears to be greater compared to more developed markets (Hilton 1994).

An important reason for inadequate levels of disclosure in ECMs relates to cultural attitudes consistent with secrecy and lack of transparency over corporate affairs (Jaggi 1975; Gray 1988). Hofstede (1980) asserted that societies with strongly collectivist orientation, which include most developing countries, share a strong sense of "in group" versus "out group" identity. This cultural orientation results in restricting the access of corporate outsiders to corporate information which is seen as being reserved for members of the "in group" only. These cultural attitudes are reinforced by the nature of large domestic enterprises in these countries, most of which are owned or controlled by family/clan-based groups. The phenomena of cross-ownerships and interlocking directorates are generally more prevalent in less-developed countries where economic wealth tends to be concentrated among a few, well-positioned groups in society (ADB 1986, 1995).

Factors creating a strong demand for adequate financial information also tend to be weaker in ECMs. The absence of a strong domestic investor base reduces pressure for companies to disclose information. Groups that

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can act as information mediators, i.e., an active and critical financial press and a competent corps of investment analysts/security brokers, also tend to be fewer in number and less sophisticated in ECMs as compared to their counterparts in developed markets (Feldman and Kumar 1994).

Even if securities regulators perceive that some degree of mandatory disclosures are necessary in ECMs, however, care should be taken to ensure that such regulation enhances, rather than stifles, the growth of domestic securities markets. As Dye (1985, 545) explained, in an environment where firms had incentives to not disclose information voluntarily, accounting regulators must consider these incentives in evaluating the consequences of alternative mandatory reporting procedures. First, imposing a greater number of mandatory requirements does not necessarily increase the amount of information available to investors because mandatory and voluntary disclosures are complementary, such that information produced by mandatory requirements are offset by a reduction in voluntary disclosures.

Second, the choices made by firms with respect to accounting policies are themselves source of valuable information. As suggested by Gonedes and Dopuch (1974), accounting policy choices represent signals of private information.[5] As such, imposition of mandatory requirements could remove this potentially important source of information for investors.

Third, in an environment characterized by increasingly globalized financial markets, accounting regulators should moderate the imposition of costly disclosure requirements if their market is to remain competitive as a site for raising capital. Saudagaran (1991), for example, noted recent U.S. SEC reforms aimed at streamlining disclosure requirements for foreign firms intending to raise capital in U.S. capital markets. These reforms appear judicious in the context of empirical evidence provided by Saudagaran and Biddle (1992, 1995) for Europe, North America and Japan where firms were reluctant to list in stock markets in countries where disclosure requirements were perceived as being too stringent. These findings are consistent with Walter's (1993, 18) call for "adequate rules governing disclosure, transparency and conduct of business (including insider trading) providing protection to international as well as domestic equity investors while at the same time avoiding *overregulation* that raises transactions costs and impairs market liquidity and innovation" (emphasis added).

Achieving an optimal balance of regulation is one of the most important issues facing securities regulators today, particularly in emerging capital markets. Overall, on the basis of current conditions in ECMs, our view is that a "voluntary" or "laissez faire" approach is not appropriate in ECMs because of cultural attitudes that inhibit full disclosure and weaknesses in institutional capability to demand adequate information. We recommend that the government take a more active role in specifying minimum disclosure requirements, which do not have to be as onerous or extensive as those required in more-developed capital markets such as the U.S. and U.K., but are sufficient to provide a basis for making sound investment decisions. It seems appropriate, too, that ECMs could model their disclosure requirements on the more successful emerging or "newly developed" markets such as Malaysia, Singapore and South Africa.

Strengthening Enforcement Capability

Several factors account for differences in enforcement capability with respect to financial reporting regulations in ECMs. First, government attitude towards capital market development in general and financial reporting in particular varies across countries. In some countries, the development of active capital markets is afforded high priority in government policy making. In other countries, a more *dirigiste* approach to financing is emphasized with the government playing a direct role in harnessing and allocating credit in domestic

[5] Cooper and Keim (1983) assert, however, that the signal associated with accounting choices must be unambiguous and credible if it is to be effective.

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industries (Frankel 1993). Second, enforcement appears to be stronger if a designated government agency is responsible for regulating the securities market (World Bank 1989; IMF 1992, 1994). These government agencies usually perform functions similar to the SEC, including formulating rules for public issuances of securities, approving specific offers of securities and listings, and defining the overall direction of capital markets development. Finally, the size and quality of the accounting personnel significantly impacts the enforcement capability in a country (Heaston 1984). Countries that have well-established accounting professions with a sizable membership body generally have stronger policy-making and enforcement capabilities with respect to financial reporting. Policy makers need to focus on each of these factors if they are to address the problem of inadequate enforcement of financial reporting regulations in the long term.

Another pressing policy dilemma facing regulators in ECMs is the extent to which the private sector should participate in setting and enforcing financial reporting rules. In some ECMs, greater reliance is placed on government edicts with respect to financial reporting. Reliance upon mandatory disclosures specified in law is apparent in countries such as China, Indonesia, Poland and Peru. These laws require a greater degree of standardization of financial reporting practices. In comparison, a policy of private sector self-regulation is encouraged in other ECMs. The accounting profession in these countries often plays an important role in specifying the financial reporting standards applicable to private companies, including those listed in their stock exchanges. Examples of such countries include Nigeria, South Africa, Malaysia and Mexico.

The choice of an overall regulatory approach potentially affects the capability to enforce accounting rules in these countries. Arguably, government-defined uniformity of accounting requirements facilitates the review of enterprise compliance with these rules. Uniformity also imposes less demands on skilled and professional accountants, who are generally in short supply in many ECMs. Conversely, uniformity based on strict government control could also inhibit the development of a more responsive financial reporting system. It has been observed, for example, that financial reporting is generally more "sophisticated" in countries that assign a greater role to the private sector, particularly the accounting profession, in shaping regulations (Wallace and Briston 1993). Changes, apart from being implemented more rapidly, also are more likely to incorporate recent innovations in financial markets, such as the introduction of trading in financial derivatives, compared to countries that adopt a government-led regulatory approach.

On the basis of the above discussion, it seems appropriate that ECMs in their early stages of development should emphasize government-defined uniform accounting requirements. This option helps to maximize the use of scarce professional accounting personnel, facilitates compliance with extant requirements, and "educates" enterprises regarding the need to provide adequate financial and non-financial information.Effective enforcement of these reporting rules requires also that a statutory regulatory agency with sufficient administrative resources be established. For most ECMs, the model often used is that of the SEC.[6] Conversely, as ECMs reach a particular size and maturity and attain a greater number of well-trained accounting professionals (e.g., Argentina, Malaysia and South Africa), regulators should allow the private sector, i.e., stock exchanges and professional accounting bodies, to play a more active role in setting and enforcing financial reporting policies. The statutory regulatory agency could then play a supportive and supervisory role by monitoring the performance of these private sector organizations and by imposing credible, yet judicious, penalties for violations of extant rules.

[6] Recent examples of ECMs that have adopted this model include Indonesia, Malaysia, Poland and Thailand.

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Whether or not governments adopt a more uniform, government-led approach or a flexible, private-sector oriented approach to accounting regulation, the critical policy issue facing most ECMs relates to increasing the number and quality of accountants and auditors in the country. In general, the most successful ECMs are those which have implemented a long-term program to enhance the capabilities of their tertiary institutions and strengthened corresponding programs for continuing professional education (Wallace and Briston 1993). Multinational lending institutions are often involved in efforts to improve the accounting capability in ECMs. The World Bank, for example, is involved in a long-term project to enhance all aspects of accounting development in several ECMs (World Bank 1990). Development of accounting professions in ECMs can also be facilitated by participating actively in international forums and organizations dealing with financial reporting. Regional organizations such as the Asociacion Interamericana de Contabilidad (AIC), the Confederation of Asian and Pacific Accountants (CAPA), and the Federation des Experts Comptables Européens (FEE) are invaluable in that they afford members opportunities to discuss issues of common concern and learn from approaches developed in other countries.

Harmonization of Accounting Standards

Finally, the third and probably one of the most contentious policy issues facing regulators in ECMs is whether, or to what extent, an active program of accounting harmonization is to be pursued. The issue is particularly important for countries adopting market-oriented economic policies after years of state central planning. Policy makers will have to grapple with issues regarding the most appropriate financial reporting system for their country (Samuels and Oliga 1982; Wallace 1993). The alternatives range from adopting aspects of regulation in economically advanced countries to formulating a system uniquely tailored to their particular circumstances (Ndubizu 1992). If accounting harmonization emerges as a preferred policy, a choice has to be made on whether accounting harmonization will be pursued following a regional or global model. The actual choice, however, will depend, on the concurrent, yet diametrical, effects of regionalization and globalization on individual countries.

On the one hand, the formation of regional economic groups indicates the growing economic interdependence of countries that are geographically proximate. Regional economic groups such as the European Union (EU), the North American Free Trade Area (NAFTA) and the Association of South East Asian Nations (ASEAN) have become prominent players in the global investment and trade arenas. Efforts to create regional economic policies will inevitably draw attention to financial reporting issues, as the experience of the EU has shown (Thorell and Whittington 1994).

In such a setting, the regional model of accounting harmonization represents an appealing policy option for countries. The regional model, referred to as the "cluster approach" to accounting harmonization, possesses specific advantages in terms of recognizing the shared interests of the member countries (Choi 1981). Countries that are geographically proximate often share similar characteristics in terms of their historical, political, economic and cultural backgrounds. Regional accounting harmonization could be pursued to enhance further the level of economic linkages among countries in the region. Already, the European Union (EU) has pursued accounting harmonization vigorously in the context of the member countries' company laws. Regional accounting groups have likewise been proposed for ECMs located in Latin America, Southeast Asia and Francophone Africa (Choi 1981; Forrester 1983; Rivera and Salva 1995).

The other significant trend is the increasing level of integration of global financial markets. Globalization of finance is an increasingly significant policy issue for developing and transitional economies seeking to augment their domestic resources with foreign capital. Pressures to revise and transform

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their financial reporting systems emanate from a variety of international sources. Foreign institutional investors can express their preferences for particular types of accounting regimes, e.g., accounting standards patterned after the U.K. and U.S. Multilateral financial institutions such as the World Bank also support particular types of financial reporting. Under such an environment, the global model of accounting harmonization represents a rational policy alternative for ECMs (Beresford 1995). Adoption of IAS is consistent with moving toward the global concept of harmonization. On the one hand, IAS offer credible accounting standards for countries that do not have the resources to develop their own standards or that desire the benefits associated with possessing "globally acceptable accounting standards" (IAS 1982, 1989). Some IAS, however, could be inappropriate for the needs of ECMs. In the long-term, the extent to which developed markets subsequently support IAS is crucial in the decision of ECMs to adopt IAS (Purvis et al. 1991). Such reasoning is plausible to the extent that worldwide capital flows are still dominated by the developed capital markets. The juxtaposition of the dominant sources of global capital and requirements of ECMs for external sources of capital creates conditions auspicious for the adoption of accounting methods preferred in the leading developed capital markets, particularly Japan, the U.K. and U.S.

Pursuing accounting harmonization is not a risk-free policy option for ECMs. The principal risk relates to the possibility that accounting standards adopted are inappropriate for the particular ECM (Samuels and Oliga 1982; Wallace 1993). The greater risk, however, is for an ECM to become uncompetitive because it does not have a sound basis of accounting that can be understood by investors elsewhere. In an increasingly interdependent and globalized economy, some form of accounting harmonization seems warranted. This assertion is particularly salient for ECMs because these markets depend substantially on the inflow of foreign portfolio investments for their continued growth. Rather than having such harmonization occurring by default, accounting regulators in ECMs should make a deliberate choice of countries with whom they wish to harmonize their domestic accounting standards. The specific choices will depend on existing and planned economic linkages as well as political and socio-cultural similarities between the model country and adopting country. Where regional economic groups (e.g., NAFTA, Mercosur) have been formed, some consideration given to a regional harmonization policy seems appropriate. We also provide qualified support for the use of IAS in emerging markets. In our view, ECMs are likely to benefit substantially from adopting IAS if and when the International Organization of Securities Commissions (IOSCO), which comprises securities market regulators in both developed and emerging markets, endorses the revised accounting standards currently being developed by the IASC. Otherwise, there is no guarantee that IAS will be acceptable to international investors, the group whose interest ECMs are trying to attract in the first place.

CONCLUSION AND FURTHER RESEARCH

In this paper, we argue that sound financial reporting is central to the development of ECMs. The extent to which ECMs can address pitfalls and difficulties associated with their financial reporting rules and practices contributes significantly to the ability of these markets to attract global capital inflows.

Three characteristics of financial reporting were identified as being particularly relevant to ECMs. These characteristics are the availability, reliability and comparability of financial and other information. Information *availability* was viewed in terms of the extent and quality of disclosures necessary for making investment decisions. ECMs were generally found to be lagging in terms of their levels of disclosures compared to developed capital markets. Differences in disclosure levels, however, could be explained by different information requirements in ECMs vis-à-vis more developed capital markets. Information *reliability* was linked to the soundness of

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domestic accounting standards as well as the enforcement capability in the country. At present, more than half of emerging markets have adopted IAS, either partially or fully, suggesting that IAS are perceived in these countries to be a sound basis for formulating domestic accounting standards. Moreover, ECMs possessed different capabilities with respect to enforcing existing standards because of constraints found in each country's national environment. Finally, *comparability* was argued to encompass two important aspects. On the one hand, differences in domestic accounting standards, quite prevalent among ECMs, affected the comparability of financial reports in these countries. In addition, the underlying environments in each country provided the contextual basis for interpreting the accounting numbers. Accounting harmonization generally focuses on a single facet of comparability, that of dissimilar accounting standards. As such, harmonization provides only a partial solution to the problem of comparing enterprises in different national settings.

Research regarding financial reporting in ECMs needs to consider the implications of various financial reporting policies on the political, economic and socio-cultural conditions in LDCs (Wallace 1993). In this regard, three urgent areas of research were identified in the paper. With respect to information availability, it is relevant to examine the implications of a mandated versus a voluntary approach to disclosure. The costs and benefits of these alternative approaches need to be considered in the context of ECMs, given their enforcement capabilities and reliance on external sources of capital. While the overall tendency is towards mandated disclosures, achieving an optimal balance of regulation appears more difficult to achieve in practice (Biddle and Saudagaran 1991).Indeed, inadequate disclosure could seriously reduce investor confidence in the market. Conversely, burdensome disclosures could discourage otherwise qualified companies from raising capital in stock markets because the perceived costs of compliance far outweigh the benefits of listing.

Enforcement of accounting regulation in ECMs is another important area of research. The "best" accounting standards are only as good as the effectiveness of the regulatory process. Systematic inquiry needs to be made regarding the strength of regulatory mechanisms in ECMs, the factors limiting their effectiveness and possible remedies for limitations that are uncovered. The issue of strengthening enforcement in ECMs was related to preferences for a government-led or a private sector-oriented approach to regulation. Uniform accounting requirements appear to provide benefits in view of the limited enforcement capability in ECMs. Nonetheless, research needs to examine further whether a private sector-led accounting regime, similar to those that exist in the U.K. and U.S., is more appropriate for ECMs. Methods for increasing the number and quality of accounting personnel in ECMs was also seen as an important adjunct to enforcement effectiveness, regardless of the regulatory approach adopted in a country.

Finally, research into comparability needs to analyze the impact of accounting harmonization on ECMs. Despite calls for increased accounting harmonization, little is known about the real benefits and costs of accounting harmonization for countries. For example, will the adoption of IAS provide greater benefits to emerging markets (e.g., in terms of attracting more foreign investment) or will such adoption retard the development of their capital markets? A recent study indicates that adoption of IAS in LDCs was associated with lower economic growth and lower stock market development (Larson 1993). Further research into the reasons behind these findings needs to be undertaken. Another dimension of the comparability issue which requires further inquiry is the importance of contextual factors underlying accounting numbers. Knowledge of these contextual factors will assist users in correctly interpreting the significance of accounting information in ECMs which, in turn, would lead to better investment decisions in regard to these markets.

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