

## II. Importance of Sound Accounting and Auditing Practices

### 1. Introduction

**G**overnance arrangements affect development outcomes. One examination of 175 economies found strong positive relationships between good governance arrangements and per capita incomes, infant mortality rates and literacy rates.<sup>9</sup> Another study reinforced evidence that while gross domestic product (GDP) growth is the most powerful poverty reducer, it is not enough; among other things, countries can double their living standards by improving their legal systems and combating corruption, special emphasis should be placed on deepening domestic financial markets, strengthening regulation and financial supervision, and introducing effective corporate governance mechanisms.<sup>10</sup> There is certainly a strong correlation between an economy's number of accountants and per capita income (see Figure 1).

Accounting and auditing practices underpin governance arrangements. This chapter reviews evidence that sound accounting and auditing mechanisms: (i) attract investment; (ii) support financial market development; (iii) reduce country risk premiums; (iv) improve privatization outcomes; and (v) lower the risk of financial crises, but when crises do occur, reduce their severity and duration.

### 2. Attracting Investment

In 2001, despite an estimated 42 percent fall in global Foreign Direct Investment (FDI) to \$760 billion, net FDI flows to emerging market countries were estimated to have held steady at \$163 billion.<sup>11</sup>

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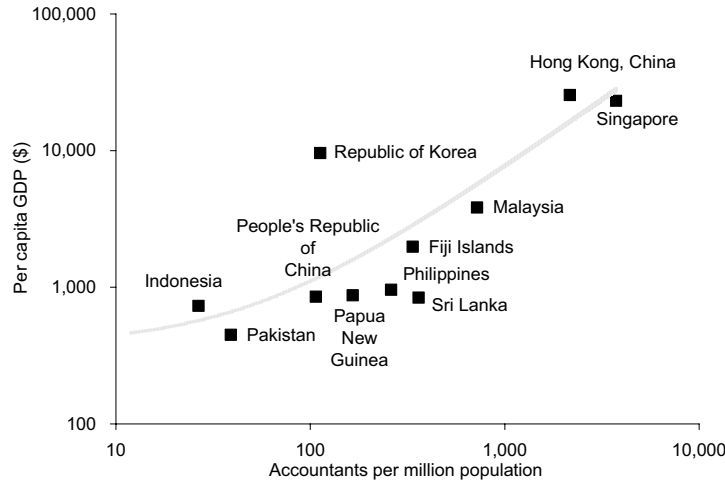
<sup>9</sup> Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobaton. 2002 February. *Governance Matters II: Updated Indicators for 2000/01*. World Bank Policy Research Working Paper No. 2772. Kaufmann, Daniel, Aart Kraay and Pablo Zoido-Lobaton. 1999 October. *Governance Matters*. World Bank Policy Research Working Paper No. 2196.

<sup>10</sup> Thomas, Vinod, Ashok Dhareshwar, Ramon E. Lopez, Yan Wang, Nalin Kishor, Mansoor Dailimi, and Daniel Kaufmann. 2000 August. *The Quality of Growth*. World Bank and Oxford University Press.

<sup>11</sup> IMF. 2001. *World Economic Outlook: December 2001*. World Economic and Financial Surveys. Washington: IMF.

However, the International Monetary Fund (IMF) expects net FDI flows to emerging markets to reduce.<sup>12</sup>

Figure 1: Accountants and Per Capita GDP (2000-02)



Various sources including: ADB. 2001. *Key Indicators of Developing Asian and Pacific Countries. Volume XXXII*. Manila: ADB; ADB Diagnostic Studies of Accounting and Auditing.

A recent cross-country survey of institutional investors revealed that most are prepared to pay a premium for companies exhibiting high governance standards. Premiums averaged 12-14 percent in North America and Western Europe, 20-25 percent in Asia and Latin America, and over 30 percent in Eastern Europe and Africa. More than a third stated they would avoid investments in countries with poor governance. Importantly, the survey reveals that accounting practices strongly influence investor decisions (see Figure 2).<sup>13</sup>

<sup>12</sup> IMF. 2002 March. *Global Financial Stability Report: Market Developments and Issues*. World Economic and Financial Surveys. Washington: IMF. pp. 21-22.

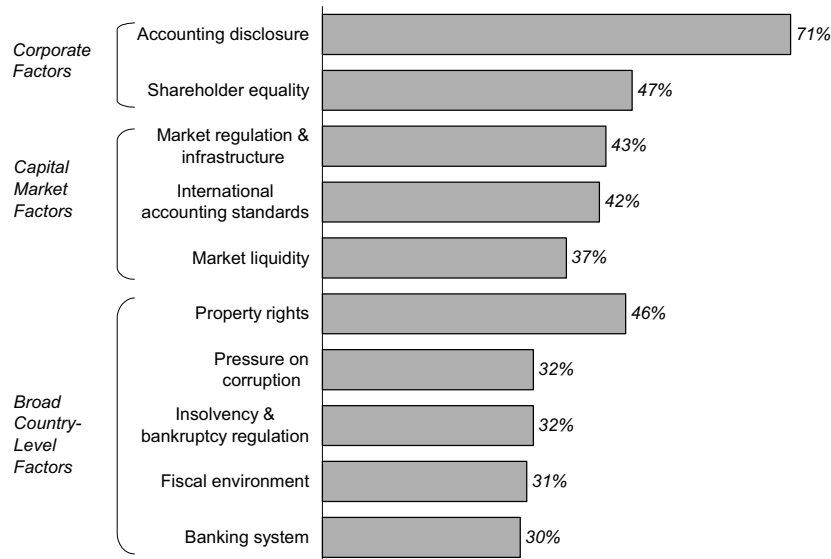
<sup>13</sup> McKinsey & Company. 2002 July. *Global Investor Opinion Survey on Corporate Governance: Key Findings*.

### 3. Supporting Financial Market Development

Financial markets (arguably) facilitate economic development through more efficient allocation of capital.<sup>14</sup> It is contended that sound accounting and auditing arrangements encourage financial market development.<sup>15</sup>

Figure 2: Very Important Factors Influencing Investor Decisions

McKinsey & Company asked 200 major institutional investors from Africa, Asia, Europe, North America and South America to identify very important factors that influenced their investment decisions. The top ten factors—and the percentage of respondents who included these factors in their top ten list—are shown.



Source: McKinsey & Company. 2002 July. *Global Investor Opinion Survey on Corporate Governance: Key Findings*.

<sup>14</sup> See, for instance: Schumpeter, J. A. 1911. *A Theory of Economic Development*. Cambridge, MA: Harvard University Press; King, R. and R. Levine. 1993. Finance and Growth: Schumpeter Might Be Right. *Quarterly Journal of Economics*. Vol. 108: pp. 681-737; Rajan, R. and L. Zingales. 1998. Which Capitalism? Lessons from the East Asian Crisis. *Journal of Applied Corporate Finance*. Vol. 11. pp. 40-48.

<sup>15</sup> See, for instance: Barth, M., G. Clinch, and T. Shibano. 1999 January. International Accounting Harmonization and Global Equity Markets. *Journal of Accounting and Economics*. Vol. 26. pp. 201-235; Most, K. 1972 October. Sombart's Propositions Revisited. *The Accounting Review*. Vol. 47. pp. 722-734; Watts, R. and J. Zimmerman. 1983 October. Agency Problems, Auditing, and the Theory of the Firm: Some Evidence. *Journal of Law and Economics*. Vol. 26. pp. 613-634; Yamey, B. 1964. Accounting and the Rise of Capitalism: Further Notes on a Theme by Sombart. *Journal of Accounting Research*. Spring (2). pp. 117-136.

“High quality accounting standards result in greater investor confidence, which improves liquidity, reduces capital costs and makes fair market prices possible.”

– Arthur Levitt (1998), p. 81.<sup>16</sup>

Indeed, a recent study found that higher quality accounting and auditing practices are positively associated with financial market development in countries with stronger legal protection.<sup>17</sup>

Furthermore, developing and transitional countries often have weak investor protection laws, which are associated with concentrated ownership, lower levels of outside (minority) ownership and less developed financial markets.<sup>18</sup> It has been suggested that weak investor protection may be more effectively addressed through strengthened accounting and auditing practices, rather than by more-difficult-to-implement legal reforms.<sup>19</sup>

#### 4. Lowering Country Risk Premiums

In early 2001, PricewaterhouseCoopers (PwC), an international consulting firm, produced an *Opacity Index*. This measure weighs the effects of unclear legal systems and regulations, macroeconomic and tax policies, accounting standards and practices, and corruption on the capital markets of 35 countries. Russia is the most opaque, and the US and Singapore the most transparent.<sup>20</sup> Opacity generates a country risk premium that deters foreign investors. For example, PwC estimates that the premium on an Indonesian government bond issue, relative to a US one, is more than 10 percent (see Figure 3). Some opacity premiums are higher than the actual interest rate at which particular countries are able to borrow. PwC contends that certain capital market dynamics and hidden subsidies explain this apparent anomaly.

<sup>16</sup> Levitt, Arthur. 1998 March. The Importance of High Quality Accounting Standards. *Accounting Horizons*. Vol. 12. pp. 79-82.

<sup>17</sup> Francis, Jere R., Inder K. Khurana, and Raynolde Pereira. 2002 May. The Role of Accounting and Auditing in Corporate Governance and the Development of Financial Markets Around the World. Paper Presented to the 2002 International Symposium on Audit Research, July 2002, Sydney, Australia.

<sup>18</sup> La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny. 1998 December. Law and Finance. *Journal of Political Economy*. Vol. 106. pp. 1113-1155.

<sup>19</sup> La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny. 2000 February. Agency Problems and Dividend Policies Around the World. *Journal of Finance*. Vol. 55. pp. 1-33.

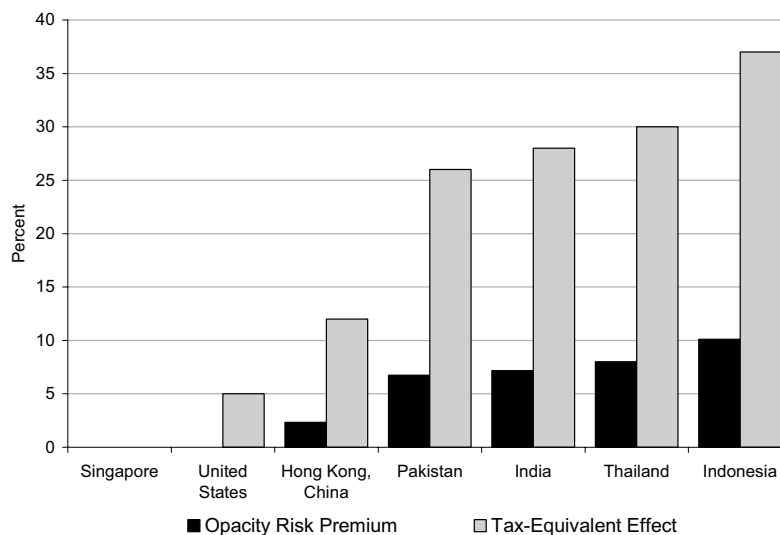
<sup>20</sup> *The Economist*. 2001 March 1. Transparency. p. 110.

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The *Opacity Risk Premium* indicates the increased cost of borrowing faced by countries due to opacity. On average, countries with more opacity pay higher interest rates on issued debt. For example, a score of nine indicates that countries need to pay international investors an extra 9 percent on their sovereign debt due to opacity.

The *Tax Equivalent Effect* estimates opacity impacts when viewed as a hidden tax. For example, the number 30 indicates that opacity in that country is equivalent to levying an additional 30 percent corporate income tax. The best-practice country is scored at zero and serves as the benchmark (i.e., US and Singapore for opacity, and Singapore for the tax equivalent effect).<sup>21</sup>

Figure 3: Estimated Opacity Effects: Seven Selected Economies



Source: PricewaterhouseCoopers. 2001 January. *The Opacity Index*. PwC Worldwide.

5. Improving Privatization Outcomes

Country and enterprise accounting systems, financial information and audit methodologies, play a critical role in the success of privatizations. However, the accounting structures and processes of many government enterprises are inadequate.

<sup>21</sup> The Opacity Factors for Singapore and the US are 29 and 36, respectively. Although the study assigns zero *Opacity Risk Premiums* to both countries, it differentiates for *Tax Equivalent Effects* (i.e., Singapore is scored at zero and the US at five).

Evidence suggests that privatization will be more difficult if financial management issues are not addressed beforehand. There is also evidence that unreliable or inadequate financial information can reduce privatization proceeds, through valuation difficulties.<sup>22</sup>

## 6. Reducing Crisis Risks and Mitigating Crisis Effects

An ADB study found that poor enforcement of corporate regulations, underdeveloped capital markets and high concentrations of corporate ownership were the main reasons for weak corporate governance in the economies that were most affected by the 1997-98 Asian financial crisis.<sup>23</sup> It recommended: (i) rationalizing corporate ownership structures (ownership concentration should be reduced); (ii) bolstering corporate internal controls and shareholder protection; (iii) improving external monitoring and discipline; and (iv) developing capital markets and improving the efficiency of corporate financing. The study concluded that measures to strengthen corporate internal control, improve standards of accounting, auditing and financial reporting systems and their enforcement “should be placed on top of the reform agenda”.<sup>24</sup>

There is also evidence that the buildup, duration, and severity of bubbles in equity and real estate markets, as well as the restructuring that occurs in their aftermath, are related to the availability of skills in financial sector services. Countries that have capable professionals such as accountants, appraisers, analysts and insolvency experts, recognize and respond more swiftly to asset bubbles than countries with limited financial sector skills.<sup>25, 26</sup>

<sup>22</sup> See, for instance, Enthoven, Adolf. 1998. Privatization and the Role and Impact of Accounting and Auditing. University of Texas at Dallas: Paper presented at 21<sup>st</sup> EAA Congress: Accounting in Times of Transition. Antwerp, April 1998.

<sup>23</sup> Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. Manila: ADB.

<sup>24</sup> *Ibid*, p. 86.

<sup>25</sup> Allen, Franklin and Douglas Gale. 2000 January. Bubbles and Crises. *Economic Journal*. 110. pp. 236-55.

<sup>26</sup> Pomerleano, Michael (Lead Financial Specialist, World Bank). 2002 April. Back to the Basics: Critical Financial Sector Professions Required in the Aftermath of an Asset Bubble. *The Appraisal Journal*. pp. 173-181.



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“The strong correlation among the base of skills, the growth of non-bank financial intermediation and the stability of the financial system suggests that poor prevention and weak responses to financial crises are linked to inadequate skills and human capital in the financial services sector.”<sup>27</sup>

### 7. Conclusion

This chapter reviewed evidence that sound accounting and auditing practices support economic development. The importance of accounting and auditing arrangements should not be understated; even minor reductions in a country’s risk premium will free up significant public sector resources (by reducing debt-servicing payments) and make more private sector investments viable (by lowering investment-hurdle rates).

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<sup>27</sup> *Ibid.* p. 175.