FINANCIAL INFORMATION QUALITY ACROSS THE CAPITAL MARKETS POSITIONED AT DIFFERENT LEVELS OF DEVELOPMENT

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Actuality

On the surface, financial reporting only enters the calculations of many in terms of its technical functionality. A more rigorous exploration, however, helps to conceptualize it as an integral component of business operations, market dynamics, and the economy in general. Financial reporting embodies a deep utility as pertains to the creation of overall welfare as investors base their investment decisions on the reported financial information (Zimmermann and Werner 2013). While the early wave of 19th century on disclosure regulation focused on the mandatory preparation of financial statements based on historic cost, a new wave of thinking started on the premise that financial reporting's primary goal is the information of existing and potential investors on the value of the enterprise. There is a consensus that high quality decisions on the allocation of capital improve the overall performance of an economy (King and Levine 1993; Levine and Zervos 1996; Meser et al. 2015; Stulz 2000) and that investors need to base their decisions on reliable financial information (Akerlof 1970; Bhattacharya et al. 2003; Biddle and Hilary 2006; Biddle et al. 2009; Black 2001; Bradshaw et al. 2004; Dechow and Schrand 2004; Pirveli and Zimmermann 2015; Rajan et al. 2000; Steier, 2009; Verdi 2006). However, it is by no means clear how investors are best informed about the value of their investment. This may be done by high quality financial statements, but how the reliability of financial information varies across capital markets positioned at different levels of development still remains to be elusive.

State of Research in the Field

The process and resulting substance of financial reporting is contingent on numerous environmental factors (Ball et al. 2000; Daske et al. 2008), of which, the extent of capital market development stands as one of the most topical (Ali and Hwang 1999; Pirveli 2014; Soderstrom and Sun 2007). Ball and Shivakumar (2005: 4), while analyzing UK public and private firms, argue that a market's demand for financial information constitutes one of the strongest incentives in the reporting process. Likewise, Teoh et al. (1998) state that capital market incentives importantly determine the quality of financial numbers by affecting accounting choices, particularly accruals choices. Academics hypothesize that the relation between the extent of capital market development and the quality of financial information is positive. The underlying recognition is that strong capital markets are capable of gathering large pools of investors who formulate a demand on representative financial data and push corporate managers to be diligent in the reporting process. That is, at the strong capital markets corporate managers are under concomitantly higher degrees of pressure to provide sensible financial information (Dechow and Schrand 2004). Accounting empiricism (e.g., Ball et al. 2003; Burgstahler et al. 2006; Dechow and Skinner 2000; Leuz et al. 2003) also assists the hypothesis on a positive link between the two. E.g., by using proxies for earnings smoothing and accruals manipulation of non-financial industries across 31 countries, findings by Leuz et al. (2003) suggest a positive relationship between the extent of capital market development and accounting quality – evident in terms of decreased engagement in earnings management (also see: Ali and Hwang 1999; Burgstahler et al. 2006).

Research Gap

While the positive relation between the extent of capital market development and financial information quality is known, it is by no means clear whether this positive relation increases or decreases as we shift our analysis from more towards less developed capital markets and/or vice versa. Understanding such relation would help investors to more precisely formulate their estimations on the trustiness of financial information provided at various capital markets. This is of particular for the investors at less developed capital markets where due to data unavailability/unreliability and limited research capacity reasons the existing knowledge on the quality of financial information is inferior and investors are unaware at what extent to rely on them. For example, Georgian Stock Exchange as one of the last developed capital markets worldwide is barely able to attain investors' attention and this is considerably driven by the existing ambiguity on the trustiness of the reported financial information (Pirveli and Zimmermann 2015). This research project by investigating the second degree relation between the extent of capital market development and the quality of financial information aims to explore the uncharted territory and help investors in formulating more precise predictions on the quality of financial information in less developed capital markets.

Research Design

Analyzing quantitative data will be the corner stone of the project. At a first stage, a capital market development (CMD) ranking will be established for a large number of capital markets. The work will cover 106 capital markets for which the data on stock market properties (size and liquidity) is available at the World Bank database. Consistent to the prior literature (Demirgüç- Kunt and Levine 1996; La Porta et al. 1997; Zimmermann and Werner 2013), market size and liquidity, as crucial building blocks in assessing the extent of capital market development, will serve as proxies to understand how big is a capital market and whether the size is further met by the intensity of trading. As next, the work will identify five country subgroups named as advanced (top 5 countries in the CMD rating), developed (top 5 countries of the 75th percentile in the CMD rating), developing (top 5 countries of the 50th percentile in the CMD rating list), underdeveloped (top 5 countries of the 25th percentile in the CMD rating list) and undeveloped (bottom 5 countries in the CMD rating) capital markets. The Georgian Stock Exchange as one of the least developed stock markets worldwide (see: Pirveli and Zimmermann 2015) will be grouped within the last subgroup. Detailed market and financial firm-level data of the JSC companies registered at those 25 stock exchanges will be retrieved from the Datastream database. Comparative analysis of financial information quality matrix across these subgroups will extrapolate whether there is a systematic difference in financial information quality across the capital markets positioned at different levels of development and whether this difference increases or decreases while shifting from more towards less developed capital markets.

Previous studies (Ball and Shivakumar 2006; Ball et al. 2003; Burgstahler et al. 2006; Leuz et al. 2003) base their findings on one of the measurements of the financial information quality such as earning management or accounting conservatism. This limits our understanding of the quality of financial information in a wide sense. For instance, judging merely from the earnings management perspective, it could be concluded that an intentional manipulation of earnings is not a prevalent approach at a certain stock market, and that earnings, therefore, show a high reliability. However, these earnings might appear as weak summary measurements of a firm performance in terms of weak association with the stock prices. This is of especially high prevalence for less developed economies where market incentives on earnings manipulation appear to be weak whereas corporate managers are limited in their understanding of accruals' fundamentals and their working process (Dechow and Schrand 2004; Pirveli 2015). To cover a holistic picture of financial information quality and not merely limited by its one of the measurements, this research project will operationilize the quality matrix via its four large pillars such as value relevance of accounting information (Ball and Brown 1968; Holthausen et al. 1995), time-series properties of earnings (Freeman et al. 1982; Lev 1983; Sloan 1996; Xie 2001), earnings management (Jones 1991; Dechow et al. 1995; Goncharov and Zimmermann 2007) and accounting conservatism (Basu 1997; Ball and Shivakumar 2005).

The proposed research project will cover the years of 2001-2015. To mitigate methodological challenges and to capture inter-temporal changes across countries, industries, years, accounting standards, and firm-specific characteristics (firm size, profitability, financial leverage, and a growth rate), in robust analysis OLS regressions will be employed with robust standard errors clustered in respect to these variables.

Foreseen Achievements

We estimate that the extent of capital market development is a significant driver of the quality of financial information, and that the driving power increases as we switch from more towards less developed capital markets. This is because in less developed capital markets such as Georgian stock exchange, we expect, in addition to low demand on financial information and poor investor protection, for a limited accounting and audit profession and therefore an inferior understanding of accruals-based transactions which markedly worsen the quality of financial information. Basing our conclusions on rigorous empirical analysis will enable us to developed convincing recommendations for policy-makers as pertains to increased attention to the accounting profession and for investors as pertains to more precise firm valuations.

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