# LAW AND REPORTING COMPLIANCE CONFIDENCE

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**Abstract**

This study investigates the relationship between investor protection and the reporting compliance confidence in 24 countries, reported in an EY's survey. In particular, we examine whether differences in investor protection across countries are related to confidence in reporting compliance, reporting complexity in terms of number of reporting standards, and number of reports issued. The results suggest that firms in countries with stronger investor rights have more reporting standards to comply with, and that these firms also have an increase in reporting demand from stakeholders as compared to firms in countries with weaker investor rights. We provide empirical evidence that the strength of investor rights has a significant effect on reporting

quality and practices, whereas the strength of legal enforcement does not have the same effect.

## INTRODUCTION

Rapid globalization of financial markets is evidenced by the increasing number of firms cross-listed in international stock exchanges and by the widespread adoptions of International Financial Reporting Standards (IFRS) in the past two decades. However, significant differences exist in the quality of financial reporting among countries. EY published a recent report, "Are you prepared for corporate reporting's perfect storm?" in February, 2016, which provides survey results of 1,000 chief financial officers (CFOs) and heads of reporting in large organizations in 25 countries/regions in terms of their confidence in compliance with their accounting, finance, controlling and sustainability reporting needs. The average confidence among the countries is only 55%, with a wide range between 13% and 83%. The overall low average confidence reflects the increasing demand from various stakeholders and rising complexity of reporting standards. This wide range of confidence is an indication that quality of financial reporting varies substantially across countries.

La Porta et al. (1998) examined the differences in investor protection in 49 countries. This study is one of the most highly cited papers in the literature and has over sixteen thousand citations by March, 2016 according to Google Scholar. The authors suggest that investor protection is affected partly by the availability of investor rights and partly by legal enforcement. From analyzing the enacted investor laws and legal enforcement practices, they find that countries with common-law origin have the strongest investor rights and legal enforcement, while countries with French-civil-law origin have the weakest investor rights. Since the publication of this paper, many accounting researchers have examined whether international differences in the quality of financial reporting are affected by differences in investor protection in various countries. The idea is that in countries with strong investor rights and/or legal enforcement, managers are less likely to engage in accounting manipulations given the severe legal consequences when the manipulations are revealed.

The objective of this article is to examine the relationship between investor protection and the CFO confidence in different countries as reported in the EY's survey. Prior studies have focused on the investigation of the effects of investor protection on reporting quality in terms of earnings management and accounting restatements. We examine whether differences in investor protection among countries are related to confidence in reporting compliance as well as to reporting complexity in terms of number of reporting standards and number of reports issued. The findings of this study can further enhance our understanding of the effects of investor protection on current reporting differences across countries. The rest of this paper is organized as follows. Section 2 summarizes the related literature. Section 3 reports the empirical design and findings. Section 4 provides the conclusions of this study.

## RELATED LITERATURE

Leuz et al. (2003) examined the relationship between earnings management and investor protection in 31 countries from 1990-1999. Using two income smoothing measures and two reporting earnings discretion measures, they found that firms in countries with stronger shareholder rights and legal enforcement have less earnings management. Behn et al. (2013) investigated the extent of classification shifting in 40 countries. Classification shifting is defined in academic literature as the accounting manipulation in shifting core expenses to special items in order to portrait better core earnings to investors. The authors examined 6,000 firm-year observations in 1998-2008 for firms in 40 countries including the United States. They found strong evidence of significant classification shifting among firms in countries with either strong or weak investor protection. However, the classification shifting manipulation is more severe among firms in countries with weaker investor protection.

Srinivasan et al. (2015) examined the frequencies of accounting restatement among U.S.-listed foreign firms and similar U.S. firms in 2000-2010. Foreign firms are matched with U.S. firms in terms of firm size, leverage, return on assets, and book-to-market ratio. The authors found that foreign firms report accounting restatements significantly less often than those of U.S. counterparts. In addition, foreign firms from countries with weaker rule of law are significantly less likely to report accounting restatements than foreign firms from countries with stronger rule of law. Since the lower frequency of accounting restatements may be due to poor detection of material accounting errors and/or less material accounting errors, the authors examined the sample firms' internal control disclosures under Section 404 of Sarbanes-Oxley Act.

They found that while the U.S. firms and foreign firms from countries with strong rule of law have a significant positive relationship between accounting restatement and material internal control weaknesses disclosure, foreign firms from countries with weak rule of law do not exhibit such a relationship. As such, the authors concluded that the lower frequency of accounting restatement reports among foreign firms from countries with weak rule of law is due to the weak legal enforcement in their countries.

Hooghiemstra et al. (2015) examined the amount of internal control information that firms voluntarily disclosed in their annual reports. The sample consisted of 1,559 firms in 29 countries, excluding the U.S., in 2005-2007. They found that the amount of voluntary disclosures was positively related to individualism and negatively related to uncertainty avoidance, which are two different aspects of national culture. In addition, they found that the amount of voluntary disclosures in internal control was positively associated with shareholder rights using the shareholder rights of the original measure from La Porta et al. (1998) and of the updated measure from Djankov et al. (2008).

Chen (2016) examined the more severe cases of disclosure manipulation. The author investigated the characteristics of U.S.-listed foreign firms which have violated Rule 19(b)-5 of the 1934 Securities and Exchange Commission Act. These firms have been accused of intentionally providing material misstatement of financial information to investors and their shareholders have filed class action lawsuits again them in the United States. The author collected a sample of 260 class action lawsuits against U.S.-listed foreign firms originated from 33 foreign countries in 1996-2013. The analysis showed that firms from countries with weaker legal environments are more likely to face class action lawsuits in the U.S. as compared to those from countries with stronger legal environments.

A bonding theory has been developed in the literature suggesting that firms from foreign countries with weak investor protection can list their shares on U.S. exchanges in order to bond themselves with stronger investor protection rules [Stulz (1999); Coffee (2002)]. However, the findings of this study and of the literature show that listing in the U.S. by foreign firms alone is insufficient in resolving the weak investor protection issue since differences in reporting quality still exist among foreign firms after their U.S.-listings. Interestingly, the author also found that foreign firms that use Big 4 as auditors are significantly less likely to have class action lawsuits as compared to foreign firms that do not, after controlling for other firm and country characteristics.

Chan et al. (2015) examined the 20-F filing lags of foreign firms listed on U.S. exchanges. Form 20-F for U.S. listed foreign firms is similar to Form 10-K for U.S. firms. In 2008, the Securities and Exchange Commission changed the 20-F filing deadline from six months after the fiscal year-end to four months after the fiscal year-end for fiscal years ended December 31, 2011 in order to provide more timely information to investors. Although the authors found that the average filing lag after the regulation change has reduced, firms from countries with weaker investor protections continued to have longer filing lags. This finding shows that the effect of investor protection on firms' disclosure practices is positive, but that the legal bonding effect of foreign firms traded in U.S. exchanges is not perfect.

Khurana and Michas (2011) examined the effects of IFRS adoptions and U.S. home bias. U.S. home bias refers to the tendency of U.S. investors to invest in domestic firms rather than in foreign firms since they are more familiar with U.S. firms' operations and financial disclosures. The authors investigated whether IFRS adoptions by foreign countries will reduce the bias against holding foreign companies by U.S. investors. They collected the U.S. investors' portfolio holdings of foreign securities from the information published by the U.S. Treasury Department in 2003-07 for 85 countries.

In the sample, 22 countries have already adopted IFRS before 2003, 33 countries adopted IFRS in 2003-07, and 30 countries continue to use local accounting standards. The authors found that U.S. home bias has decreased for foreign countries after their IFRS adoptions. This is consistent with the idea that IFRS can reduce the cost of processing accounting information in the global economy. The authors also found that the reduction in U.S. home bias is more profound among countries with stronger investor rights and legal enforcement. This finding suggests that U.S. investors consider firms from countries with stronger investor protection to have a more credible application of the IFRS. This highlights the importance of legal and corporate governance reforms in improving disclosure quality.

Chan et al. (2012) examined the changes in audit fees of U.S.-listed foreign firms due to Section 404 of Sarbanes-Oxley Act of 2002. The Securities and Exchange Commission initially required all U.S. accelerated filers to report on the effectiveness of their internal control over financial reporting for fiscal years ended on or after November 15, 2004 under Section 404 of Sarbanes-Oxley. Non-accelerated filers and U.S.-listed foreign firms were required to comply with Section 404 in the following year. The compliance dates for foreign firms was later changed. Foreign large accelerated filers were required to fully comply with Section 404 for fiscal years on or after July 15, 2006.

Foreign accelerated filers were only required to provide management reports on internal controls in 2006 and to fully comply starting in the following year with both auditor and management Section 404 reports. Non-accelerated U.S. and foreign filers were not required to comply with Section 404. The authors found that foreign large accelerated filers had an average of 74% increase in audit fees in the first year of Section 404 compliance which is similar to that of the U.S. firms.

The increase in audit fees among foreign large accelerated filers is significantly higher than those among foreign accelerated filers and among foreign non-accelerated filers given the additional audit work involved. In the audit fee literature, the amount of the audit fees is mainly determined by the amount of audit work and by the potential legal liability for the auditor. This study also finds that the increase in audit fees is higher for firms from countries with weaker investor protection. This is consistent with the notion that firms from countries with weaker investor protection tend to have lower reporting quality and the additional Section 404 auditor review may increase auditor liability more than that of firms from countries with stronger investor protection and reporting quality.

## EMPIRICAL DESIGN AND FINDINGS

Table 1 lists the key findings from the EY's survey on confidence in reporting compliance of 24 countries. The EY survey covers 24 individual countries and one region. Our sample excludes the MENA (Middle East and North Africa) region in the survey since it includes several countries. About half of the survey respondents are group, divisional, or regional CFOs, and the rest of the respondents are group, divisional, or regional controllers. The surveyed organizations are mainly large firms, with over 60% of them having annual revenues of $5 billion or more, and 21% of them have annual revenues of over $20 billion. The EY survey also covers 14 main industries.

Table 1 shows the range of compliance confidence among countries, and Table 2 presents the summary statistics. The average confidence of reporting compliance is 55% with a minimum of only 13% and a maximum of 83%. The compliance confidence fluctuates over a wide range. The EY survey suggests that one key reason for the lack of compliance confidence is the complexity of financial reporting. Complexity of reporting is reflected by number of reporting standards, and by increasing number of reports requested from various external as well as internal stakeholders.

The reporting standards and needs range from regular financial reporting to local regulatory filings and social responsibility reports. Using the country level values, Table 2 shows that almost half of the surveyed firms have to comply with 10 or more reporting standards and about 69% of the firms are facing increasing number of reports requested. Overall, it shows that CFOs and heads of reporting units are not very confident in reporting compliance and the complexity of reporting is increasing.

Prior studies suggest that quality of financial reporting is associated with the extent of investor protection. Based on the literature, investor protection is affected by the amount of shareholders rights and legal enforcement. The protection of minority investor rankings from the World Bank is a common measure of investor rights. Corruption perception index ranking from Transparency International is often used as a measure of legal enforcement in prior studies. We collected the most recent 2015 rankings from these two sources, and the summary statistics are reported in Table 2 as well.

Countries with stronger shareholder rights to protect minority shareholders are ranked higher. Countries with lower corruption problems have higher corruption perception rankings. The average protection minority investor ranking is 40 among the

24 sample countries, ranging from 1 to 134. The average corruption perception index ranking is 38 in our sample with the highest ranking of 1 and the lowest ranking of 119. We expect that countries with stronger investor rights and legal enforcement have higher reporting compliance confidence and reporting complexity.

Table 3 reports the analysis of the relationship between reporting compliance confidence and investor rights. The 24 sample countries are classified into two groups. The first group contains the 12 countries with protection minority investor rankings higher than the sample median value. The second group contains the other 12 countries with protection minority investor rankings lower than the sample median value.

Panel A of Table 3 shows that the average compliance confidence among countries with stronger investor rights is 60.58% while the average compliance confidence among countries with weaker investor rights is only 49.83%. Both the mean and median differences between the two groups are statistically significant at the 10% level. Panel B shows that among countries with stronger investor rights, they have an average of 52.5% of firms with more than 10 reporting standards.

As for countries with weaker investor rights, they have an average of 43.75% of firms with more than 10 reporting standards. The mean and median percentage differences among the two groups of countries are statistically significant at 5% level. Finally, Panel C shows that among countries with stronger investor rights, they have an average of 73.83% of firms with increasing number of reports requested from stakeholders. On the other hand, among countries with weaker investor rights, they have an average of 64.33% of firms with increasing demand of reports from stakeholders. The mean difference of the two groups is statistically significant at the 10% level.

Table 4 reports the results of the analysis on the effects of legal enforcement on reporting compliance confidence. Among countries with higher corruption perception rankings, the average reporting compliance confidence average is 56.33% and the average percentage of firms with 10 or more reporting standards is 50.16%. These countries also have an average of 68.91% of firms with increasing reporting demand from stakeholders. As for the lower corruption perception ranking group, their respective averages are 54.08%, 46.08%, and 69.25%. However, there is no statistically significant in these three respective averages between the high and low ranking groups.

## CONCLUSIONS

This study examines the effects of investor protection on reporting compliance confidence reported in a recent EY survey of 24 countries. We find that for countries with stronger investor rights, there is stronger reporting compliance from CFOs and heads of reporting units. The results also suggest that firms in countries with stronger investor rights have more reporting standards to comply with, and that these firms also have an increase in reporting demand from stakeholders as compared to firms in countries with weaker investor rights.

However, the results show no significant difference in reporting compliance confidence, number of reporting standards, increasing demand for reporting needs among firms in countries with stronger or weaker legal enforcement as measured by Transparency International's corruption perceptions rankings. Overall, we document empirical evidence that is consistent with the literature, that the strength of investor rights has a significant effect on reporting quality and practices.

Our findings do not provide empirical evidence to support the argument that stronger legal enforcement has the same effect.

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**Table 1**

**Compliance Confidence and Complexity of Reporting**

| Countries | Confidence in degree of compliance of reporting | Complies with > 10 reporting standards | Increase in number of reports requested |
|---|---|---|---|
| Australia | 40% | 33% | 53% |
| Belgium | 48% | 60% | 65% |
| Brazil | 78% | 68% | 80% |
| Canada | 68% | 40% | 68% |
| China | 65% | 40% | 68% |
| Denmark | 58% | 50% | 93% |
| France | 65% | 53% | 68% |
| Germany | 65% | 45% | 68% |
| India | 45% | 50% | 60% |
| Italy | 33% | 43% | 55% |
| Japan | 43% | 48% | 68% |
| Mexico | 53% | 55% | 78% |
| Netherlands | 40% | 43% | 63% |
| Norway | 48% | 65% | 93% |
| Poland | 70% | 40% | 70% |
| Russia | 53% | 48% | 63% |
| Singapore | 83% | 65% | 80% |
| South Africa | 63% | 58% | 63% |
| South Korea | 33% | 43% | 60% |
| Spain | 78% | 25% | 73% |
| Sweden | 48% | 63% | 90% |
| UK | 60% | 50% | 58% |
| US | 75% | 40% | 28% |
| Vietnam | 13% | 30% | 93% |

Source: EY's Financial Accounting and Advisory Services (FAAS) 2016 survey, Are you prepared for corporate reporting's perfect storm?

**Table 2**

**Summary Statistics**
(n = 24)

| Variables | Mean | Median | Minimum | Maximum |
|---|---|---|---|---|
| Confidence in degree of compliance of reporting | 55% | 55% | 13% | 83% |
| Complies with > 10 reporting standards | 48% | 48% | 25% | 68% |
| Increase in number of reports requested | 69% | 68% | 28% | 93% |
| Protecting minority investor ranking | 40 | 35 | 1 | 134 |
| Corruption perception ranking | 38 | 23 | 1 | 119 |

Confidence in degree of compliance of reporting, complies with > 10 reporting standards, and increased in number of reports requested are collected from EY's Financial Accounting and Advisory Services (FAAS) 2016 survey, Are you prepared for corporate reporting's perfect storm?
Protecting minority investor rankings for 2015 are collected from World Bank.
Corruption perception rankings for 2015 are collected from Transparency International.

**Table 3**

**Compliance Confidence and Reporting Complexity by Protecting Minority Investors Ranking**

Panel A: Confidence in degree of compliance of reporting

| | Mean | Median |
|---|---|---|
| Stronger investor rights group | 60.58% | 61.50% |
| Weaker investor rights group | 49.83% | 50.50% |
| Difference | 10.75%* | 11.00%* |

Panel B: Complies with > 10 reporting standards

| | Mean | Median |
|---|---|---|
| Stronger investor rights group | 52.50% | 51.50% |
| Weaker investor rights group | 43.75% | 43.00% |
| Difference | 8.75%** | 8.50%** |

Panel C: Increase in number of reports requested

| | Mean | Median |
|---|---|---|
| Stronger investor rights group | 73.83% | 70.50% |
| Weaker investor rights group | 64.33% | 66.50% |
| Difference | 9.50%* | 4.00% |

Stronger investor rights group includes the 12 countries in the sample that are above the sample mean in terms of protecting minority investor ranks.
Weaker investor rights group includes the 12 countries in the sample that are below the sample mean in terms of protecting minority investor ranks.
* and ** are 10% and 5% significant, respectively in two-sample t-test of means and two-sample Wilcoxon test of medians in one-tailed test.

**Table 4**

**Compliance Confidence and Reporting Complexity by Corruption Perception Ranking**

Panel A: Confidence in degree of compliance of reporting

| | Mean | Median |
|---|---|---|
| Higher corruption perception group | 56.33% | 53.00% |
| Lower corruption perception group | 54.08% | 58.00% |
| Difference | 2.25% | -5.00% |

Panel B: Complies with > 10 reporting standards

| | Mean | Median |
|---|---|---|
| Higher corruption perception group | 50.16% | 49.00% |
| Lower corruption perception group | 46.08% | 45.50% |
| Difference | 4.08% | 3.50% |

Panel C: Increase in number of reports requested

| | Mean | Median |
|---|---|---|
| Higher corruption perception group | 68.91% | 68.00% |
| Lower corruption perception group | 69.25% | 68.00% |
| Difference | -0.34% | 0.00% |

Higher corruption perception group includes the 12 countries in the sample that are above the sample mean in terms of corruption perception ranking.
Lower corruption perception group includes the 12 countries in the sample that are below the sample mean in terms of corruption perception ranking.