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THE QUALITY OF PUBLISHED ACCOUNTING INFORMATION IN RUSSIA
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Abstract

Since the collapse of the Soviet Union Russia has undergone a number of reforms towards developing market economy. Accounting has encountered dramatic changes over the last two decades. Despite attractive investment opportunities in Russia, investors are often faced with uncertainty, which makes it very important to explore the quality of accounting information published in Russia. The purpose of this thesis is to investigate the quality of published accounting information in Russia. The thesis consists of four essays, each of them addressing the question of the quality of accounting information published in Russia by incorporating the specific Russian institutional environment. Special attention is paid to the role of International Financial Accounting Standards (IFRS) and foreign investors.

The quality of published accounting information is conceptualized by such accounting constructs as conservatism, earnings management and value relevance. This first essay investigates the earnings quality of both listed and non-listed Russian firms and explores whether foreign ownership affects the quality of earnings published by non-listed Russian firms. The second essay examines whether emphasis on international investors is associated with the adoption of or intention to adopt IFRS in Russian firms. The third essay addresses the question of IFRS and Russian Accounting Standards (RAS) accounting quality by using the methodology proposed by Barth et al. (2008) and by value relevance constructs of accounting quality. The fourth essay investigates the value relevance of firms’ integral environmental impact, i.e. a proxy for environmental performance, following the stream of non-financial information value relevance in accounting research.

This thesis provides evidence that the quality of published accounting information published in Russia depends on many factors, the most influential of these being listing on the stock exchange, IFRS and foreign investors. The results of the thesis demonstrate that the institutional characteristics of the country shape accounting numbers and influence the incentives of those preparing financial statements. The findings of the thesis include information valuable for regulators and investors.

Keywords: accounting quality, environmental performance, financial reporting, IFRS, RAS, Russia, transitional economies
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Oulu 25th April 2010

Alexandra Bagaeva
List of original publications

The thesis consists of an introductory chapter and the following essays:


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1 Introduction

“Not with the mind is Russia comprehended,
The common yardstick will deceive
In gauging her: so singular her nature
In Russia you must just believe.”

(Tютчев 1866, in Yarmolinsky 1949:88)

The accounting phenomenon in Russia has been under the influence of the major historical changes in the last century. It was marked by the advent and the rule of the Soviet party for almost 75 years in Russian history, followed by the collapse of the Soviet Union and the pursuit of a market economy. The period in the most recent history of Russia starting from 1991 up to the present day has witnessed a number of economic reforms, the development of the stock market, the formation of a whole new accounting system and the initiation of the accounting and auditing profession (Bailey 1995). Russia is still undergoing a transition process from a command economy to a market economy, which necessitates economic reforms and the establishment of a new institutional and legal framework.

It is generally known that accounting information from financial reports has a great impact on the behaviour and decision-making of its users, namely investors, managers and the state. In accounting studies covering a wide range of topics starting from management and ending with financial accounting, one may find examples of the usefulness and relevance of accounting information in most European countries, Australia, Asia and in the USA (e.g. Kothari 2001, Verrecchia 2001). At the same time accounting in Russia remains one of the most under-researched areas in the accounting literature. Despite a handful of studies dealing with accounting in Russia (Enthoven et al. 2001, McGee & Preobragenskaya 2006, Goncharov & Zimmerman 2006), there is no solid research on the most common attributes of accounting quality, such as value relevance, conservatism and earnings management. This absence of scientific research can be partly explained by the complexities of the accounting phenomenon in Russia and its cultural embeddedness in the Russian past and present.

While Russia is considered to be an attractive country to foreign investors, because of its qualified labour supply, vast natural resources and its geographical proximity to Europe, its transitional nature involves a high degree of uncertainty.
This has been reflected in considerably lower foreign direct investment (FDI) levels in Russia than, e.g. in China. The accounting information provided by Russian firms needs to be scrutinised. Using financial accounting quality concepts, this thesis investigates the quality of accounting information in Russia relying on such factors as the role of foreign investors and International Financial Accounting Standards (IFRS). Major emphasis is placed on the incentives of those involved in the financial accounting statements preparation. Furthermore, the Russian transitional context is intensively incorporated into the study.

Taking into consideration the transitional state of the economy in Russia, the purpose of this study is to examine the quality of accounting information published in the nascent Russian market economy, while paying attention to the development of accounting in Russia and keeping in mind the most influential forces in this process, such as the role of foreign investors and IFRS. The topic of this thesis is in line with accounting studies emphasising the role of institutional environment influencing the properties of published accounting information and the incentives of managers and auditors (e.g. Ali & Hwang 2000, Ball et al. 2000, Fan & Wong 2001, Leuz et al. 2003, Bushman & Piotroski 2006, Barth et al. 2008 etc.). Therefore, this work continues this research tradition by investigating the quality of accounting information in Russia and reflecting on the impact thereon of the institutional environment. Moreover, looking at the incentives of those preparing financial statements, it is possible to see how such incentives permeate the quality of accounting information in Russia. For, example, keeping everything fixed, the Russian firm in need of foreign equity capital is more likely to begin acting more proactively by improving the quality of the published accounting information and by adopting IFRS, because these are the ways to demonstrate commitment and increase transparency.

The thesis is composed of four independent essays, with three common themes running through all of them: accounting quality in Russia, the role of international investors and the role of IFRS. All these themes are very much interrelated, however, there is no search for a causal relationship. The role of foreign investors and IFRS serve as anchors uniting the thesis into an entity allowing for a multi-angle coverage of the research topic.

The contribution of the thesis relates to the literature on the role of incentives in the quality of accounting information (Ball & Shivakumar 2005, Barth et al. 2008, Christensen et al. 2008) by expanding models used in earlier research and providing empirical evidence from the Russian transitional economy. The thesis also contributes to the discussion on the influence of institutional country

The remainder of this introductory chapter is organized as follows. Accounting quality constructs and previous research thereon are reviewed in Section 2. Section 3 deals with accounting in Russia, summarising the most important development stages of accounting in Russia and drawing upon the legal framework as well as reviewing the situation on the stock market. Section 4 focuses on the research framework by outlining the research questions, research structure and drawing on research contributions. Sections 5 concludes.
2 Constructs of accounting quality

The quality of accounting information derived from financial reporting is a widely used term in financial accounting research. However, there is no consensus on the definition of accounting quality in general. There are different approaches that attempt to capture the phenomenon of accounting quality from financial reports by evoking accounting earnings and its characteristics such as earnings persistence, predictive ability and variability of earnings (Schipper & Vincent 2003) and other information from the financial statements. Accounting information quality can be described in terms of decision usefulness and reliability for the users. As accounting information becomes less reliable, it becomes more difficult for equity investors to evaluate a firm’s true performance. While it is difficult to formulate an exact definition of accounting information quality, one might understand that, for instance, manager manipulation and earnings management could serve as primary cause of impaired information quality.

The accounting literature uses different approaches and concepts to conventionalise accounting information quality to be measured or tested empirically. For the purposes of this thesis the following constructs measuring accounting information quality have been chosen: conservatism, value relevance and earnings management. The rationale behind choosing these constructs is based on their versatility and applicability, meaning that they have been employed in many studies worldwide (Kothari 2001), as well as by the existence of a fully articulated theory on these constructs. Furthermore, by incorporating conservatism, value relevance and earnings management into the examination of accounting information quality it is possible to achieve a more holistic picture on the state of accounting in Russia. The use of these constructs moreover makes it possible to extend the existing research by shedding light on the state of these issues in the transitional Russian economy. In the following subchapter each of the accounting information quality constructs used in this thesis will be examined in more detail.

2.1 Conservatism

Conservatism has a history of long and significant influence on accounting practice and, thus, on accounting research. The most common definition of conservatism identifies it as “the accountant’s tendency to require a higher
degree of verification to recognise good news as gains than to recognize bad news as losses” (Basu 1997, 7). Therefore, conservatism requires an asymmetrical degree of verification for gains versus losses. According to Watts (2003) conservatism originated and has persisted because of contracting, litigation, taxation and regulation considerations. The same factors triggering conservatism have also been documented by Ball (2001), Ball & Shivakumar (2005) and Basu (2005). Conservatism also serves as a mechanism for reducing information asymmetry between firm insiders and outside equity investors by reducing the manager’s incentives to manipulate accounting numbers (LaFond & Watts 2008).

In investigating conservatism it is important to pay attention to two different types of conservatism: unconditional and conditional conservatism. Unconditional conservatism refers to accounting policies that consistently underestimate net assets, for instance, such procedures as full expensing of R&D, accelerated depreciation and avoiding the recognition of self-originated intangibles. In light of Watts & Zimmerman’s (1986) discussion, unconditional conservatism means that the accountant should report the lowest value among the possible alternative for assets and the highest value for liabilities. Another definition of unconditional conservatism by Beaver & Ryan (2005) states that unconditional conservatism is *ex ante* in nature or news independent, meaning that this type of conservatism only utilizes information known at the inception of the asset’s life. Conditional conservatism refers to more timely recognition of loss events and delayed recognition of gains, generating earnings that reflect bad news in a timelier fashion than good news (Basu 1997). Conditional conservatism can be viewed as *ex post* or news dependent conservatism (Beaver & Ryan 2005). The examples of this type of conservatism may be lowering of cost or market accounting for inventory and impairment accounting for long-lived tangible and intangible assets. Starting with Basu (1997) a body of research has investigated the association between share returns and earnings finding a stronger association when returns are negative, hence demonstrating the asymmetry.

In empirical studies researchers use different constructs for measuring conservatism, which as in (Watts 2003) can be divided into the following categories: book-to-market measures, valuation model measures, earnings/accrual measures and earnings and stock returns relation measures. Book-to-market and valuation model measures are used for investigating unconditional conservatism, as they make it possible to obtain the understatement of net assets caused by unconditional conservatism (Ahmed et al. 2000, Beaver & Ryan 2000). Meanwhile earnings and accrual measures, as well as earnings and stock returns
relation measures capture the impact of conditional conservatism due to the asymmetrical treatment of gains and losses under conditional conservatism.

Both types of conservatism serve many of the same purposes, including reducing information asymmetry, minimizing firms’ litigation risk, tax, or regulatory costs. In contracting agreements conservatism by requiring asymmetric verifiability of gains and losses constrains managerial opportunistic behaviour. By means of conditional conservatism contracting efficiency can be improved, given general managers’ tendency to report upward-biased accounting numbers (Beaver & Ryan 2005), if one looks at debt contracts, which are commonly written in terms of variables reported in the financial statements, such as interest coverage or financial leverage. Monitoring of debt contracts is facilitated if conditional conservatism is applied, as debt-covenant violations are triggered faster. Also, timely loss recognition gives managers less incentives to undertake ex ante negative-NPV projects (Ball & Shivakumar 2005). Consistent with the contracting explanation of conditional conservatism Ball et al. (2008) find that conservative accounting limits the opportunities available for manipulation of the reported variables included in debt contracts by restricting decisions made by loss-making managers that could further erode debt quality. Regarding taxation and regulation, Ball (2001), Ball and Shivakumar (2005) and Basu (2005) argue that they are likely to induce only conservatism in its unconditional form. Moreover, based on the studies by Ball and Shivakumar (2005) and Basu (2005) it is possible to conclude that contracting and litigation are the reasons for conditional conservatism. To conclude, both types of conservatism are likely to reduce income and equity, but the timing of these reductions is different, since only conditional conservatism provides new information that generates contracting responses.

In the last two decades research on conservatism has attracted great attention in accounting. There are large cross-country studies such as that by Bushman & Piotroski (2006) examining the influence of legal and political institutions on incentives for conservative accounting. Raonic et al. (2004) focuses on set of European countries in investigating interrelation between country-level disclosure regimes, legal enforcement and importance of equity markets on conservatism. Furthermore, the issues of the country institutional background and forces have been incorporated into the research by Ball et al. (2000) and Ball et al. (2003). Depending on the demand for accounting income in each given country, Ball et al. (2000) find that accounting income properties vary across countries. In four East
Asian countries Ball et al. (2003) observe various levels of conditional conservatism depending on the country’s institutional framework.

For the purposes of this thesis a conditional conservatism measure by Ball and Shivakumar (2005) is applied. The rationale behind choosing this approach lies in the applicability of their conservatism measurement for investigating conservatism in both public and private firms, because the measure of timeliness is based on the transitory nature of economic income and does not require stock returns. Moreover, it is possible to examine how incentives for providing high quality accounting information differ in Russian private and public firms as well as to see what impact foreign ownership has on conservatism in Russia.

2.2 Earnings management

The most common definition of earnings management is the manipulation of a company's financial earnings either directly or through indirect accounting methods. This happens when a company is unable to meet investor expectations or in periods of volatile earnings. Earnings management is often viewed as a misleading and fraudulent activity.

Researchers have classified the incentives for earnings management into: stock market purposes, contracting and regulatory motivations (Healy & Palepu 1999). In stock market purposes managers are likely to manage earnings before equity offers, e.g. (Dechow et al. 1996), or to meet the expectations of financial analysts or management (Burgstahler & Eames 1998). For contracting motivations earnings management is likely to produce misleading financial statements which could affect resource allocation (Healy & Wahlen 1999), this suggests that compensation and lending contracts induce at least some firms to manage earnings to increase bonuses, improve job security, and mitigate potential violation of debt covenants. First, earnings management for any reason can potentially lead to misleading financial statements and affect resource allocation. Second, financial reporting is used for communicating management information not only to stock investors, but also to debt investors and to investors' representatives on boards of directors. It has been documented that regulatory considerations induce firms to manage earnings, for instance to manage industry-specific regulatory constrains. Adding to the existing motivations for earnings management this thesis incorporates the Russian institutional environment and builds on the notion of tax incentives and attracting foreign investors as considerations for or against earnings management.
Empirical constructs for measuring earnings management vary from study to study. However, according to McNichols (2000), they can be classified into aggregate accruals models, specific accruals models and the frequency distribution approach. Aggregate accruals models include studies by Jones (1991), where a model of discretionary accruals is employed, Dechow et al. (1995), specific accruals models focus on industry settings in which a single accrual is sizable and requires substantial judgement, e.g. Beaver & McNichols (1998), Nelson (2000) and Petroni et al. (2000). The reason for investigating discretionary accruals is that managers may exploit their discretion over accounting decisions to enhance reported earnings. Accruals quality can be measured in terms of discretionary accruals using a variant of the Jones (1991) model, the modified Jones model (Dechow et al. 1995), or performance-matched discretionary accruals (Kothari et al. 2005). The third group of measures examines statistical properties of earnings to identify behaviour that influences earnings (Burgstahler & Dichev 1997).

Earnings management can be also detected in the form of earnings smoothing, documented by Defond & Park (1997), Lang et al. (2003) etc. This particular type of earnings management is scrutinized in this thesis. It has been observed that in countries with weak rule of law there is a tendency for managers to smooth earnings (Leuz et al. 2003). In their study Leuz et al. (2003) use four measures of earnings management: earnings smoothing using accruals, the correlation between changes in accounting accruals and operating cash flows, magnitude of accruals and small loss avoidance. Existing research suggests that tax incentives have a stronger influence on financial statements in countries where accounting practice is aligned with tax considerations (Ball et al. 2000, Herrmann & Inoue 1996).

When dealing with earnings smoothing, it is important to remember that earnings smoothing may on the one hand be beneficial if managers use their knowledge to communicate information about future earnings. As Russian financial statements are very much affected by tax considerations, it is more likely that earnings smoothing is used to create a smooth stream of earnings for the tax authorities to ensure risk-free relations with them. This thesis strives to disentangle different incentives for earnings smoothing in Russian firms, by investigating earnings smoothing in Russian firms using either Russian Accounting Standards (RAS), IFRS or firms using both sets of standards simultaneously.
2.3 Value relevance

The issue of financial accounting usefulness is crucial in determining the quality of accounting information. Until the 1960s accounting research concentrated mostly on normative, policy-oriented research. Value relevance studies in accounting originated from an article by Ball & Brown (1968), which first endeavoured to quantitatively measure the usefulness of earnings to investors. Further accounting thinking has developed towards examining the extent to which the information conveyed by earnings is consistent with that reflected in security returns (Lev 1989).

The value relevance stream in accounting has a large pool of studies with findings that information content of earnings merely captures some economic events that are reflected in stock prices. The most basic classification of value relevance studies falls into the categories of event and association type of studies. While event studies investigate if any event conveys new information reflected in security returns (Ball & Kothari 1991), association type of studies are aimed at testing for a relation between an accounting measure, e.g. earnings, cash flows with stock returns over a longer time window, usually one year (Collins & Kothari 1987, Easton & Harris 1991, Dechow 1994 etc.).

A few decades after the first studies on the value relevance of accounting earnings for stock prices, Lev (1989) pointed out that the correlation between earnings and stock research was very low. This discussion initiated a search for new models, incorporating information from both income statement and balance sheet for valuation purposes. One of the most-widely used models based on combining information from income statement and balance sheet is the residual income model by Ohlson (1995), which uses net income of earnings and book value of equity for valuation purposes. In the third essay this model is employed for examining whether accounting information prepared in accordance with RAS or with IFRS is more value relevant.

Recently value relevance research has been used to a large extent for the evaluation of accounting standards as well as for the investigation of the economic consequences of new accounting standards (Holthausen & Watts 2001, Healy & Palepu 2001). The impact of the adoption of IFRS in Europe has been researched extensively in a number of studies, e.g. Hung and Subramanian (2007), Bartov et al. (2005), Callao et al. (2007), Morrais & Curto (2009). There are likewise several studies investigating the value relevance of IFRS in transitional economies, e.g. (Eccher & Healy 2003), but no studies on Russia. Earlier studies
document that accounting information in countries with a strong link between tax and financial accounting is less value relevant (Joos & Lang 1994, Ali & Hwang 2000). In Russia there persists a gap on the value relevance of accounting information from financial statements, despite the importance of such information for investors. Thus, in this thesis the difference between the value relevance of Russian Accounting Standards (RAS) and IFRS is investigated.

The value relevance metric is moreover used in examining how relevant non-financial information is for investors and other groups of users (Amir & Lev 1996), in other words, what incremental value relevance non-financial information conveys in conjunction with net income and book value of equity. In the fourth essay of this thesis, the value relevance of environmental performance in Russian firms is investigated providing new evidence on the impact of non-financial information for value relevance in the Russian firms.

Value relevance studies are grounded on the assumption of market efficiency, meaning that all public information is reflected in prices. Due to the novelty of the stock market in Russia evidence of its efficiency or inefficiency is unavailable. However, earlier studies (e.g. Aboody et al. 2002, Wang et al. 2006) modelling value relevance on a possibly inefficient market conclude that although the relevance of accounting numbers would be considerably lowered if it were measured in an inefficient market, the difference is not big enough to alter the conclusions of earlier value relevance studies. Therefore, the possible inefficiency of Russian market does not prevent us from investigating the value relevance of accounting information and non-financial information.
3 The Russian institutional environment

Russia is one of the most important players in the world economy, by size its economy is ranked seventh largest in the world with the GDP growth levels averaging 7% per year in 2000–2007 (Nabiullina 2008). Russia is the largest exporter of natural gas and a country with a rich natural resource base. However, the transitional situation of Russia is reflected in the state of the Russian institutional environment. For instance, the accession of Russia to the World Trade Organization (WTO) has been delayed due to the non-conformity of the Russian legislation with WTO requirements. After the collapse of the Soviet Union, Russia had to face major economic shocks such as price liberalization, stabilization and privatization (Shleifer 1997). It had to develop a whole new set of institutions fundamental for a market economy, such as private property, convertible currency, banking system and a system for regulating the stock market (Gaidar 2007). Therefore, when investigating published accounting information quality in Russia it is essential to review the institutional environment in Russia pertinent to the accounting phenomenon, such as stages of accounting development in Russia, the role of institutional investors and IFRS, the legal system and the situation on the stock market.

3.1 Development of accounting in Russia

The evolution of accounting Russia has undergone some major changes and phases since the collapse of the Soviet Union in 1991. It is of pivotal importance to understand the influences that Russian accounting inherited from the Soviet era and what major forces formed accounting in Russia. Thereafter, the most distinctive features of Soviet accounting and Russian accounting will be examined.

In accounting terminology one may come across a term Soviet accounting (Bailey 1995), which characterises a set of methods and rules developed during more than seventy years of communist rule in the history of Russia (Fig.1.). In Soviet era of accounting from 1917 to 1990 accounting was used as a tool for control over the implementation of the state plan. Accounting became neutralised, meaning that it was unusable for purposes of taking economic action. Basically, accounting was reduced to book-keeping functions and the value of the accounting profession was degraded. The State served as the only source of accounting regulation in the Soviet Union. Starting from 1990 accounting in
Russia has entered a new epoch, because the transformation from a planned economy to a market economy required a completely new accounting system. The goals of accounting reform were to introduce market economy concepts into accounting following a gradual, evolutionary approach. The Ministry of Finance was responsible for the development of the new Russian Accounting Standards (RAS), which would be based on the principles of IFRS, but still preserving distinctive Russian features. In 1991 a new Chart of Accounts corresponding to those in developed market economies was introduced, followed by a “Law on Accounting” in 1996 which still serves as the main legislative document outlining the scope of accounting in Russia.

Fig. 1. Development of accounting in Russia from 1917 to 2010.

The Programme for the “Reformation of Accounting in Accordance with International Accounting Standards” was approved by the government in 1998. The Programme delineated the new direction of accounting development which would be concentrated on users’ needs. The development of Russian Accounting Standards (RAS), which would be based on IFRS, was launched at the same time. Since 2005 all Russian listed firms have been required to issue financial statements that comply with IFRS or US GAAP, the banks already had to file IFRS financial statements starting in 2004. In 2004 a Concept of Accounting and Reporting Development in the Russian Federation for the medium term was approved by the Ministry of Finance, which encapsulated the strategy for mid-term development. The main goals of this strategy for mid-term accounting development for the period 2004–2010 are improving the quality of accounting information, creating the infrastructure for IFRS implementation, change in the accounting regulations and improving the professionalism and skills of accountants and auditors. In 2007 a draft law On Accounting was introduced.
since the acting Law on accounting dates back to 1996, meaning that it lost its relevance and requires major amendment. However, the draft is still in the making. To sum up, accounting reforms took a longer time in Russia than initially planned and the timetable for RAS development was not adhered to. Nevertheless many economic categories are missing in the RAS and, hence, financial statements prepared in accordance with RAS are likely to lack the information needed by investors.

One of the most distinctive features in the post-soviet accounting in Russia is the tax orientation of accounting. The role of accounting was deemed to communicate tax information to the state in the Soviet Union, while in transitional Russia the state was replaced by the tax inspectorate. The main user of accounting information is still considered to be the tax inspectorate. Although in 2004 financial and tax accounting were legally separated with the introduction of Chapter 25 of the Tax Code, still due to the cost and complexity considerations in many instances only one set of financial statements was still being prepared, the one which complies with the tax law and based on RAS.

3.1.1 Role of foreign investors

In the Soviet Union all sources of finance originated from the State. After the collapse of the Soviet Union the role of foreign investors as providers of external finance has become very important for the Russian economy. The amount of foreign direct investments (FDI) grew steadily from 1995 to 2008, and GDP growth has averaged out at 5.5% (see Table 1).

### Table 1. Russia’s FDI inflows in US$ billion and GDP growth for the years 1995–2008.

<table>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>2.0</td>
<td>2.4</td>
<td>5.3</td>
<td>3.4</td>
<td>4.3</td>
<td>4.4</td>
<td>4.0</td>
<td>4.0</td>
<td>6.8</td>
<td>9.4</td>
<td>13.1</td>
<td>13.7</td>
<td>27.8</td>
<td>27.0</td>
</tr>
<tr>
<td>GDP</td>
<td>-3.6</td>
<td>1.4</td>
<td>-5.3</td>
<td>6.4</td>
<td>10.0</td>
<td>5.1</td>
<td>4.7</td>
<td>7.3</td>
<td>7.2</td>
<td>6.4</td>
<td>7.7</td>
<td>8.1</td>
<td>5.6</td>
<td></td>
</tr>
</tbody>
</table>

Notes: FDI is foreign direct investments made by legal entities or individuals wholly owning the enterprise or controlling not less than 10% of shares of its charter capital. Source: Federal State Statistics Service of the Russian Federation

The Russian stock market remains an attractive target for international investors for several reasons, e.g. stable oil prices, investors’ beliefs that the share prices of the Russian companies are undervalued. Unfortunately, there is no complete
statistics on the numbers of individuals investors engaged in stock market activities in Russia.\footnote{Based on the reports “Russian Capital Market” published in 2007 and 2008 by NAUFOR and Moscow Management School Skolkovo} The Russian stock market is of growing interest to international foreign investment funds. According to the Interfax Business Service statistics, the dynamics of foreign fund investments to Russia is as follows, 2005–1200 funds, 2006–1520 funds, 2007–1942 funds, 2008–2406 funds, showing a steady 25% growth (see Table 2). Based on the information available it is possible to conclude that about 25% of the foreign investments of foreign investments funds are made through Russian stock exchanges, while 75% is made through foreign stock exchanges. Apart from foreign investment funds, foreign hedge funds also invest in the Russian stock market, but there is no information available on them.

### Table 2. Investments of foreign investment funds to Russia.

<table>
<thead>
<tr>
<th>Variable</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of foreign investment funds investing in the Russian market</td>
<td>1200</td>
<td>1520</td>
<td>1942</td>
<td>2406</td>
</tr>
<tr>
<td>Volume of investment funds investing in the Russian stock market in US$ billion</td>
<td>22.8</td>
<td>49.5</td>
<td>73.4</td>
<td>76.4</td>
</tr>
</tbody>
</table>

Source: “Russian Capital Market” reports published in 2007 and 2008 by the National Association of Securities Market Participants (NAUFOR) and Skolkovo School of Management.

Enthoven et al. (2001) document that foreign investors have completely different needs as users of financial information than the State had during the Soviet era. When investing in Russian firms foreign investors are faced with much uncertainty regarding what determines the firm value. It has been outlined in earlier studies that without overseas investors or a large group of local interested financially literate investors, the key user of published financial reports is the tax inspectorate (Krylova 2003, Sucher & Jindrichovska 2004). Foreign investors are likely to create incentives for the firms to provide world-class comparable accounting information. Without the presence of foreign investors financial
Information is very likely to be targeted at the needs of the tax inspectorate and, thus, lack the properties important for decision-making. Moreover, it is very likely that accounting information that is reliable for tax calculation is not always relevant for other investors.

Therefore, the role of foreign investors in the transitional Russian economy is viewed throughout this thesis a stimulus for providing better quality accounting information useful for decision-making and for the implementation of IFRS. As documented by Barth et al. (1999) foreign investors are at a disadvantage when extracting information from the domestic GAAP report. Foreign investors are likely to demand high quality and transparent financial statements prepared in accordance with IFRS, because they are familiar with IFRS principles. Furthermore, prior research suggests that institutional investors exhibit a preference for high quality financial information when making international investments (Barth et al. 1999).

3.1.2 The Role of International Financial Accounting Standards (IFRS) in Russia

In the transformation of accounting in Russia the role of IFRS has been of paramount importance right from the outset. In order to be recognized as a serious player in world financial markets Russia had to acquire a great deal of overseas knowledge and expertise, which is encapsulated in IFRS. Prior research suggests that foreign investors would not invest in firms which do not publish IFRS reports. IFRS is believed to improve financial transparency, attract a greater share of equity capital and serve as an aid in decision-making. McGee & Preobragenskaya (2004) classify driving factors to IFRS transformation into external and internal. External factors include the needs of creditors and investors interested in the company’s transparency, which can be achieved by means of IFRS implementation. Internally, IFRS financial statements serve as a better source of decision making than RAS. Furthermore, IFRS are likely to strengthen corporate governance and increase confidence between managers and shareholders (McGee & Preobragenskaya 2004).

The role of IFRS is especially emphasized when compared to the existing set of RAS. IFRS are based on substance over form principles, while RAS adhere strictly to the form and to Russian Civil Law. RAS are regulated by the government. IFRS is aimed primarily at investors’ needs, while RAS continues to be targeted at tax authorities (Preobragenskaya & McGee 2004). RAS does not
have guidance for reporting in hyperinflationary economies. RAS are based on strict compliance with legal norms and requirements. RAS apply both cash and accrual cost accounting schemes. The cash basis is still quite often used in financial reports prepared in accordance with RAS because in many instances a transaction can be recognized only if all the documentation is available; in IFRS this would equal untimely recognition of transactions because IFRS require an accrual basis for transactions recognition. The greatest disadvantage of RAS that it does not provide guidance for consolidations and business combinations as well as for the impairment of assets. Fixed assets are deducted according to their acquisition price, less amortization, usually calculated according to tax norms, which does not reflect the real value of the assets. IFRS takes into consideration appraised value, which in most cases reflects market value. Depreciation of assets according to RAS is mostly done using the straight-line method because it is the one most-widely used as it stipulated by the Tax Code. The main difference between IFRS and RAS is that the concept of impairment is not applied under the Russian system. IFRS also require more disclosure in relation to assets valuation.

Apart from the advantages associated with IFRS adoption there are some drawbacks as well, according to Moody’s Global Report (2008) reporting in compliance with IFRS may involve inconsistent interpretations, false volatility and undue complexity. Due to its complexity and the absence of many economic categories in Russia, the adoption of IFRS is not so easy. Implementation of IFRS requires accountants’ professional judgment, which was absent during the Soviet period of accounting in Russia and it takes time to acquire such a skill. The main obstacle to IFRS adoption is the absence of a legally approved right to use IFRS, due its non-conformity with the Civil Law. Banks were obliged to report in accordance with IFRS in 2004, followed by public companies, which from 2005 had to submit either US GAAP or IFRS financial reports. It has been documented that the implementation of IFRS is not so straightforward in other post-soviet countries, either, e.g. Sucher & Alexander (2002), Sucher & Jindrichovska (2004).

### 3.2 Legal system

The uncertainty associated with investing in Russia is also reflected in by the state of the legal system in Russia. Russia has to a great extent inherited its legal

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system from the Soviet era (Gustafson 1999). The reforms in post-Soviet Russia have been vital in all spheres, especially in legislation. In order to enter the path towards building a new market economy, Russia had to transform its legal system to meet the expectations of the world business community. The post-Soviet Russian legal system is different from both common law and code law systems, yet closer to code law (Nysten-Haarala 2001). According to Pistor (2000), e.g. Russian Corporate law has been transplanted from the Anglo-American corporate law. In 2002 Russia introduced a Corporate Governance Code, however, in the absence of effective legal institutes and law enforcement mechanisms the good law on the books does not carry out its function. The problem lies in the weak institutions and in the lack of understanding of new laws (Pistor et al. 2000). As a result, one may observe weak law enforcement in Russia (Gustafson 1999).

Liberman and Eidinov (1995) point out that during the transitional period the creation of all components of the legal and economic framework required for smooth functioning of market economy is not feasible. Therefore, the transitional nature of the legal system in Russia affects the quality of accounting information as well, because in the absence of a well functioning enforcement system, the greater emphasis is on the financial statement preparers’ incentives. It is expected that the incentives to provide more reliable and transparent information would be in those firms which are listed on the stock exchange and are keen to attract foreign capital.

3.3 The Stock Market

A well-functioning stock market plays an important role in the transformation to a market economy, as it initiates raising money from abroad and improves corporate governance. There are two major stock exchanges in Russia: the Russian Trading System (RTS) and the Moscow Interbank Currency Exchange (MICEX), with MICEX being the largest securities trading, clearing and settlement infrastructure complex in Russia.

The development of the stock market in Russia can be traced to 1995 (see Fig.2.), when the RTS trading platform was launched, followed by the MICEX index in 1997. The MICEX Index is a capital-weighted price index of the 30 major and most liquid Russian stocks traded on the MICEX Stock Exchange the initial value of the index is 100 points), which covers nearly 80% of the market capitalization of the Russian equity market. The RTS Index, calculated by the open joint-stock company “Russian Trading System” Stock Exchange, is the
leading indicator of the Russian securities market. The RTS Index is calculated on the basis of the prices of the 50 liquid shares of the most highly capitalized Russian companies. The growth of the stock market was consolidated in 1997, when the RTS Index reached the value of 500 and since then it has continued growing steadily up to 2008, both RTS and MICEX indices having the same magnitude in growth. The peak value of the RTS Index was achieved in 2008, when it reached 2500 points, thus it grew 25-fold since its incipience in 1995.

![Graph: Micex and RTS indices 1995–2009 (Source: MICEX RTS).](image)

The total amount of market capitalization of all Russian firms had amounted to US$500 billion by the end of 2005, making it around 70% of GDP (Noel et al. 2006) and according to experts it has good potential for growth. During the years 2005–2006 the capitalization of the Russian stock market has grown more than 3.5-fold. The turnover rate is rather low, however it tends to grow, rising from 3.3 percent in 2005 to 5.1 in 2007. Initial public offerings increased in Russia during 2005–2007; 13 companies in 2005, 24 companies in 2006, and 25 companies in 2007 went public. The trading volumes have grown substantially during the last few years, for instance, taking into account that on both RTS and MICEX trading platforms the trading volumes increased from 186.0 US$ in 2005 billion to 1233.2 US$ billion in 2007 (report by NAUFOR & Skolkovo School of Management 2008).

One of the distinctive characteristics of the Russian stock market is that it is largely dominated by the natural resources sector, especially by the oil and gas
sector. Moreover, the number of firms which are traded on a regular basis is rather small, for instance in 2006 almost 85% of the total capitalization was represented by the biggest 20 companies (Lazareva et al. 2007). The branch structure of the Russian stock market capitalization is dominated by the oil and gas industry; in 2005 it accounted for 68% of all capitalization and in 2008 for 57%. However, lately other sectors of the Russian economy have significantly strengthened their positions. A considerable share in the RTS Index is now taken up by metals, financials, and electric utilities. Thus in general, although on a positive development track, the Russian stock market remains fragmented and undercapitalized (Noel et al. 2006).

Listing on the stock exchange serves as a good mechanism for improving corporate finance in Russian firms, because they have to comply with disclosure and reporting requirements (McCarthy & Puffer 2003). According to the report by the National Association of Securities Market Participants (NAUFOR) & Skolkovo Management School (2008) more than 2000 foreign investment funds are investing their money in Russian stocks and American Depository Receipts (ADRs) and the money inflow is increasing over time. Throughout this thesis listing on one of the Russian stock exchanges is viewed as a factor improving financial accounting quality, due to the disclosure and listing requirements and the use of either IFRS or US GAAP standards for financial reporting.
4 Overview of the essays

The research comprising this thesis was undertaken in the form of four independent essays. Published accounting information quality is conceptualised in terms of conservatism, earnings management and value relevance. All four essays are grounded on the notion of the accounting information being influenced by the country’s institutional make-up. Therefore, the transitional nature of Russia is incorporated into the essays. Russian environment here serves as interplay between accounting quality and forces that are most likely to affect it in the Russian case, namely foreign investors and IFRS. A great deal of attention is also paid to the role of IFRS in influencing the quality of accounting information in Russia.

4.1 Data and methods

The four essays comprising this thesis utilise Russian data. Data collection in Russia is often difficult, as noted in earlier studies (Michailova 2004), due to the reluctance of Russian firms to disclose accounting information to outsiders. Therefore, the data collected for the purposes of this thesis are decidedly unique in nature, because it necessitated a great deal of manual data collection.

The data and data analysis methods used in this thesis are presented in Table 1. In Essay 1 and Essay 3 data from the SPARK-Interfax database are utilised. The SPARK-Interfax database contains uniform information on all legal entities registered in Russia. The data come from more than ten of the most reliable official sources. Every piece of information has a reference to the source (the Federal State Statistics Service, the Federal Tax Service, the Federal Financial Markets Service etc.). All financial statement data are prepared according to Russian accounting standards.

In Essay 2 the sample of firms selected for the study was drawn from firms in the Saint Petersburg region. The candidate firms were randomly selected from the INFOWAVE Database. Next, firms were contacted and their participation was solicited. Altogether 100 firms agreed to participate in the survey, which yields an 18% response rate. The survey was conducted in the form of structured face-to-face interviews. The face-to-face method of survey was chosen because earlier studies dealing with data collection in Russia have documented that it is difficult to otherwise to gain access to reliable data (e.g. Daniels & Cannice 2004; Michailova 2004). Questionnaire design involved several stages during which
items included in the questionnaire were refined and several pilot tests were conducted (in Finland and in Russia) in order to ensure the clarity and comprehensibility of the questions. Pilot tests were conducted with people employed in academia and in the business sector. The Russian context was taken into consideration by conducting pilot testing with native speakers of Russian.

Table 3. Data and methods used in the study

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In Essay 3 and Essay 4 the Thomson WorldScope database was used to obtain data on the Russian listed firms, which was then complemented by manual data collection. In Essay 3 the manually collected data concerned firms publishing IFRS reports. These IFRS-related data were collected from firms’ websites’ financial reports. In Essay 4 manually collected data comprised NERA environmental impact ratings.

One of the limitations of the study is related to the inaccessibility of the Russian data and reluctance of the Russian companies to disclose any proprietary information as documented by earlier research (e.g. Daniels & Cannice 2004; Michailova 2004). This problem was addressed by extensive manual data collection, nevertheless, for instance in Essay 3 and Essay 4 unavailability of the data resulted in a small number of observations in the samples. Since the adoption of IFRS is a new phenomenon, even in Europe studies have been compelled to restrict themselves in their analyses to low sample sizes (Van Tandeloo & Vanstraalen 2005, Hung & Subramanyam 2007). Keeping in mind the data restrictions, the generalizability of the findings from the studies included to this thesis is limited.
4.2 Essay 1: Can Investors Rely on the Quality of Earnings Figures Published by Listed and Non-listed Russian Firms?

This essay investigates earnings quality of both listed and non-listed Russian firms and explores whether foreign ownership affects the quality of earnings published by non-listed Russian firms. Following earlier studies (e.g. Ball & Shivakumar 2005), accounting earnings quality is defined based on the timely recognition of economic losses in earnings figures (accounting conservatism). Attention is also paid to timely recognition of economic gains as they may be an important part of efficient accounting reporting (Guay 2006). Foreign investors’ impact on the quality of accounting earnings information disclosed by different types of Russian firms is the focus in this essay. Foreign investors are believed to have a positive impact on quality as the firms’ need to attract and retain foreign capital increases. More specifically, the two following empirically testable hypotheses are maintained: firstly, Russian firms listed on a stock exchange disclose earnings of good quality and, secondly, non-listed Russian firms co-owned by foreign investors disclose earnings of better quality than solely Russian-owned private firms.

The empirical results show that Russian firms listed on a stock exchange report earnings of relatively good quality, which corroborates the notion that firms listed on a stock exchange are faced with disclosure requirements and are more likely to have incentives to provide timely and reliable information to investors. However, no support is found for the hypothesis that non-listed Russian firms co-owned by foreign investors report earnings of better quality than do exclusively Russian-owned non-listed firms. Moreover, non-listed Russian firms with foreign ownership report earnings with more timely recognition of economic gains than exclusively Russian-owned non-listed firms do, which might indicate that there are differences in the demand for timely recognition of economic gains in firms with and without foreign investors.

4.3 Essay 2: An Examination of the Effect of International Investors on Accounting Information Quality in Russia

This essay examines whether emphasis on international investors is associated with the adoption of or intention to adopt IFRS in Russian firms. IFRS clearly requires higher quality reporting than existing Russian standards. The existing literature on IFRS convergence is focused almost exclusively on factors...
influencing corporate compliance with IFRS in European countries (e.g. Dumontier & Raffournier 1998; Street & Larson 2004), while the literature on IFRS adoption in emerging countries is scarce (Abd-Elsalam & Weetman 2003). It is widely believed that the use of IFRS in Russia will promote enhanced international investment in Russia, due to its familiarity to investors and due to the fact that IFRS serves as the global language of business. The results of this essay confirm that there is a positive association between international ownership of a company and the company’s willingness and intention to implement IFRS. Improving a firm’s status among foreign customers and investors is viewed as the most important reason to adopt international reports. Firms with international investors also have reasons to adopt IFRS because they are more user-friendly, help to attract international investors and improve the firm’s status among Russian customers. Along with the strong evidence on the reasons for IFRS adoption and IFRS use, the results show that the influence of international investors is conducive to change towards more transparent financial reports achieved by implementing IFRS. This result also indirectly shows that international investors demand more transparent IFRS financial reports rather than financial reports prepared in compliance with Russian accounting standards.

4.4 Essay 3: The International Financial Reporting Standards (IFRS) and Accounting Quality in a Transitional Economy: The Case of Russia

As noted by McGee and Preobragenskaya (2004), international investors demand preparation of IFRS or US GAAP reports if they intend to invest in a Russian company, meaning that listed firms would have higher incentives to provide better quality financial reports in accordance with IFRS as means of attracting international investors. The financial reports prepared according to RAS are considered to be of poorer quality than those prepared according to IFRS. This essay addresses the question of IFRS and RAS accounting quality by using the methodology proposed by Barth et al. (2008) and by value relevance constructs of accounting quality. Furthermore, value relevance analyses as in Hung and Subramanyam (2007) using a sample of firms reporting both IFRS and RAS financial reports are conducted.

The rationale behind this study lies in the assumption that accounting with RAS suffers from a lack of economic categories widely accepted and used with IFRS. This can be explained by the transitional nature of the Russian economy.
and, thus, the transitional nature of RAS. In Russia one may predict better accounting quality provided by IFRS financial statements due to the fact that they are targeted at investors’, not the tax authorities’ needs. At the same time the application of IFRS is not so straightforward due to the transitional situation of the Russian economy.

The results of this essay demonstrate that firms using IFRS exhibit higher accounting quality measured as earnings smoothing than firms using RAS. However, there is no any evidence that the use of IFRS jointly improves the value relevance of book value of equity and net income accounting in listed Russian firms, only partial support for the book value of equity value relevance improvements with IFRS for firms reporting both IFRS and RAS financial reports is found. Research evidence shows that the use of high quality accounting standards, per se, does not translate into increased value relevance of accounting figures, because numerous country specific factors, such as the level of law enforcement, legal mechanisms and the incentives of those preparing accounting information are likely to affect the final outcome of standards adoption, for example, in the case of Spain (Callao et al. 2007) and in China (Eccher & Healy 2003). This may be explained by the transitional nature of the whole accounting phenomenon in Russia. IFRS financial statements fail to provide more value relevant results for the stock market because of the absence of many economic categories in Russian reality which are inherent in IFRS; by the lack of expertise in IFRS and inability to exercise professional judgment.

4.5 Essay 4: The Value Relevance of Firms’ Integral Environmental Impact: Evidence from Russia

The fourth essay investigates the value relevance of firms’ integral environmental impact, i.e. our proxy for environmental performance, following a stream of non-financial information value relevance in accounting research. Despite a number of studies addressing the issue of environmental performance value relevance (Hassel et al. 2005, Cormier & Mangan 2007 etc), there has been no consensus among researchers on the valuation properties of environmental performance.

In our study for the proxy of environmental performance we use the integral environmental impact, which we construct based on the data provided by the Russian Independent Ecological Rating Agency (NERA). We use a unique measure of environmental performance directly addressing companies’ integral environmental impacts, capturing use of fresh water, volume of polluted sewage,
volume of emission of polluting substances, emissions from vehicles, volume of
toxic waste and total area of used and polluted lands. The data allows us to
compare the value relevance of environmental performance across companies and
industries.

In this essay data from 74 Russian listed firms for the years 2005–2007 are
used. In our analysis, we extend the literature on the valuation properties of
environmental performance (Jaggi & Freedman 1992, Dowell et al. 2000, Hassel
et al. 2005) by introducing the measure of integral environmental impact. We also
address the question of legitimacy of environmental performance disclosure by
looking into differences between firms having different disclosure policies. The
results of the study indicate that environmental performance is valued positively
in Russia, meaning that lower environmental impact is valued positively by
investors, i.e. as investment.

4.6 Contributions

The first essay contributes to the existing research investigating the quality of
accounting information globally (e.g. Ball & Shivakumar 2005, Ball et al. 2003,
Bushman & Piotroski 2006, Givoly et al. 2007) in the following three ways.
Firstly, the sample covers various types of Russian firms from large listed firms to
small private firms, all of them open joint-stock companies. This allows a direct
comparison of the foreign owner’s influence on the quality of earnings disclosed
by firms with clearly different financial reporting incentives. Secondly, there are
some earlier papers investigating the earnings management of Russian firms
(Goncharov & Zimmerman 2006), but this essay, to the best of our knowledge, is
the first to report empirical evidence on the quality of accounting information
disclosed by listed and non-listed Russian firms.

The main contribution of the second essay is in identifying the impact of
international investors on the quality of accounting information in Russia.
Secondly, we contribute to the literature, e.g. Archer et al. (1995), by studying
differences in IFRS convergence between exclusively Russian-owned and part
foreign-owned firms. This study enhances our knowledge of accounting quality in
post-Soviet Russia bringing forward the importance of international investors'impact on the quality of accounting information. The study also adds on a more
general level to our understanding of within country differences in firms in such
areas as the quality of accounting information, the use of capital finance sources
and the adoption of IFRS. On a practical level the implications of this study may
be useful for regulators in developing accounting policies in Russia for the different types of firms as well as for the investors planning business activities in Russia.

The key contribution of the third essay is in providing new evidence on the impact of IFRS on the quality of accounting information internationally (e.g. Barth et al. 2008, Bartov et al. 2005; Hung & Subramanyam 2007). We believe that the results of our investigation of IFRS application in Russia will be of interest to researchers, because we contribute new evidence on the consequences of IFRS adoptions worldwide. Furthermore, the results of our research are very topical and of great practical use for regulators in light of the imminent discussion on the reform of the accounting system in Russia. We may conclude that the use and the economic consequences of IFRS adoption in Russia are not so simple and straightforward. Even though we include a number of control variables in our analyses to mitigate the effect of economic environment and try to distinguish between firms’ incentives, we cannot fully eliminate the impact of the Russian transitional economic environment and the change in firms’ incentives to provide financial reports of lower or higher quality.

The fourth essay contributes largely to the discussion on the valuation properties of environmental performance (Jaggi & Freedman 1992, Dowell et al. 2000, Hassel et al. 2005) by introducing the measure of integral environmental impact. Furthermore, the fourth essay adds to the literature on the impact of ownership on environmental disclosure and performance (Magness 2006, Cormier & Gordon 2001, Cormier & Magnan 2003) by examining how foreign ownership affects environmental performance in Russian firms. Finally, the study contributes to the literature on the valuation properties of environmental performance by examining its cross-industry differences in valuation.
5 Conclusions

This thesis investigates the quality of published accounting information quality in Russia. Since entering the path to market economy, the accounting system in Russia has undergone major changes during the last two decades. In examining the quality of published accounting information this thesis strives to account for the major transformations occurring in the transitional Russian economy.

The thesis explores the most important facets of accounting quality through companies’ financial reports. The thesis reports extensive research on such characteristics of accounting quality as conservatism, earnings management and value relevance. Moreover, the impact of IFRS on accounting quality is examined in detail. This study follows the trend in accounting research incorporating a country’s specific institutional features into the analysis, in the case of Russia these factors are the tax orientation of accounting and the dominance of state regulation inherited from the Soviet era.

The study presents evidence that the quality of published accounting information in Russia depends on many factors, the most influential of those having a positive impact on published accounting information quality are listing on a stock exchange, IFRS and foreign investors. The results of the thesis demonstrate that the institutional characteristics of the country shape accounting numbers and influence the incentives of those preparing financial statements. The findings moreover shed light on the current state of accounting quality that could be used by investors and regulators.

Apart from providing country-specific information, the thesis contributes on a larger scale to the accounting debate in such areas as the consequences of IFRS adoption, the role of incentives in the quality of accounting information and value relevance of environmental performance.
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