Accounting Quality in Georgia: Theoretical Overview and Development of Predictions

Erekle Pirveli
Doctoral Student, Researcher
University of Bremen
Department of Accounting and Control
Hochschulring 4, 28359 Bremen, Germany

Abstract

An assessment of Georgian accounting quality is limited. This paper is supposed to be a preliminary work for the future empirical research. To the best of the author's knowledge, this is the first paper that formulates the reasonable predictions in the light of accounting quality, stemmed from rigorous analyses of accounting quality determinants within the country. Accounting quality determinants cover well-established features such as institutional landscape, market forces, accounting regime and accounting and auditing profession. Predictions on accounting quality are developed and formulated in the light of different accounting quality dimensions such as time-series properties of earnings, earnings management and accounting conservatism.

Keywords: Accounting quality, time-series properties of earnings, earnings management, accounting conservatism

JEL Classification: G14, G18, M41

1. Introduction

Financial statements are targeted to ensure its outsider users with information subject of high incorporation in a decision making process. In order to achieve this goal, disclosed accounting information should be of high quality. The importance of accounting quality (hereinafter: AQ), first and foremost, is conditioned by its positive correlation with investments' efficiency. Informative accounting amounts reduce moral hazard (extra consumption using assets in place) and adverse selection (securities issuance at an overrated price) (Bhattacharya *et al.*, 2003, 644) and help investors to devise investment decisions on the basis of efficiency. Efficient investments, in turn, promote capital to be transferred in its best use. The chain, eventually, results in the growth of capital markets (Biddle / Hilary, 2006, 964-965), a pivotal indicator of economic health (Levine / Zervos, 1996, 333). The role of efficient investments should not be undervalued for *less*-developed countries[1] as well (Chen *et al.*, 2011).

An assessment of Georgian AQ is limited. The first and last study conducted around this research area so far, belongs to the World Bank (World Bank, 2007). World Bank report (hereinafter: WBR) is decided in terms of qualitative study analyses; by separately reviewing firms' financial statements within the financial and enterprise sectors, the report summarizes that AQ within the sectors are considerably of low quality[2].

[1] Academics employ different terms (transitional -, developing -, emerging economies) while denoting economies other than those perceived as 'advanced capitalist economies'. As far as no consensus is reached which term matches to which stage of economic development, and as addressing this issue does not lie in the heart of this study, the author already registers his discomfort for potential misunderstanding, and refers to Georgia (and countries on a similar stage of development as Georgia) as a *less*-developed country.

[2] WBR distinguishes the banking sector, as the one characterized with more *representative* financial statements comparing to insurance and enterprise sectors; however, admits that still much has to be enforced in order to reach high AQ within the banking sector as well.

Here the author of this paper (hereinafter: the author) outlines an importance of further research towards the quality of Georgian accounting, and acknowledges that a conduction of explicit analyses of AQ determinants, not only would deepen the understanding how informative are accounting numbers within the country, rather would open a path to future empirical research as well. With this in mind, based on the AQ determinants' analyses, the author formulates predictions on AQ peculiarities in the light of its different dimensions such as time-series properties of earnings, earnings management and accounting conservatism.

An overall contribution of the paper lies in several folds. First, the assessment of AQ in *less*-developed countries, particularly in the Caucasian region, is scant; whereas, this study helps to fill up this bridge by examining the case of Georgia. Second, the theoretical landscape introduced in this study might be helpful for: a) Georgian authorities to gauge with determinants and causal factors of AQ, enabling them to formulate appropriate regulations towards its amelioration; b) future researchers, as the predictions formulated within this study may occur as immediately relevant to empirical-oriented accounting/finance academics; c) investors, as the paper enriches foreign and domestic investors' understandability on the viability of Georgian accounting quality and d) international organizations or foreign governments, interested in the development of capital markets in *less*-developed economies.

2. *Accounting quality determinants in Georgia*

2.1. Introduction to accounting quality and its determinants

The concept of AQ is one of the most fundamental in the overall accounting and finance literature. Despite many attempts, academics have not agreed upon a unique definition and measurement of it (Dechow *et al.*, 2010; Dichev *et al.*, 2013). According to Dechow and Schrand (2004, 5), AQ is the extent at which accounting information promotes to an accurate firm value assessment. To assess a firm value, one needs to know firm's present and future financial performance. Consequently, high AQ refers to accounting information that meticulously publicizes not only the current firm performance, rather future cash flows as well.

The candidate list of AQ measures is broad enough, inciting the author to consider its concept in the light of several dimensions, such as time-series properties of earnings, earnings management and accounting conservatism. Time-series properties of earnings include earnings persistence (the extent of current earnings that remain constant in future earnings' series) and predictability (the extent at which future earnings might be predicted via the current earnings). The both concepts are desirable from the valuation perspective (Freeman *et al.*, 1982; Lev, 1983; Lipe, 1990; Sloan, 1996) and are positively correlated with AQ.

Earnings management is managers' activity directed to intentional earnings smoothness, in order to maximize own profits and/or mislead stakeholders (Dechow *et al.*, 1995; Goncharov / Zimmermann, 2007; Jones, 1991; Leuz *et al.*, 2003). For instance, corporate managers are inspired to smooth earnings upwards before going public (as they are desired to get high stock prices) or before taking a debt (to convince creditors in their solvency). On the other hand, firms might be incited to depreciate the financial outcomes for tax accounting purposes (in order to pay less income tax). Prevalence of earnings management indicates to low AQ, as in this case, insiders alter reported firm performance either to mislead outsiders or bias contractual outcomes, clouding external financial information users' capabilities to assess *real* firm value.

Accounting conservatism refers to an asymmetric recognition of gains and losses. If economic losses are recognized in a timelier manner when compared to economic gains, the approach is perceived as a conservative accounting policy (Ball / Shivakumar, 2005; Basu, 1997; Penman / Zhang, 2002; Watts, 2003). If considered from investors' view of point, conservative accounting screens out *less*-successful businesses from investors' field of vision throughout decision making process; it eliminates the necessity of adjustments in valuation models and is perceived as an indicator of high AQ. All the three dimensions are perceived as crucial measures of AQ (Ball *et al.*, 2003; Barth *et al.*, 2005; Bartov *et al.*, 2005).

As long as, the assessment of Georgian AQ is limited, the author finds it rational thoroughly to evaluate AQ determinants, enabling to formulate more *close to reality* predictions. A long line of prior research (Ali / Hwang, 1999; Burgstahler *et al.*, 2006; Soderstrom / Sun, 2007) reveals the key AQ determinants such as institutional settings, market forces and accounting standards, strongly impacting on financial reporting. Accounting amounts are expected to be more informative in countries with strict institutional settings, *well*-developed capital markets, and rigorous accounting regimes. The author here argues that, particularly in *less*-developed countries, the determinant such as accounting and audit profession should be considered as one of the main driver of AQ.

The following part of the study examines AQ determinants such as institutional settings, market incentives, accounting regime and accounting and audit profession, within the country.

2.2. Institutional settings

2.2.1. Legal framework

In order to achieve high AQ, high quality standards/laws should be established. Prior literature (e.g., Choi / Mueller, 1992) suggests that dictated rules are as of higher quality as lesser is the extent of government involvement in standards/laws setting process. In Georgia, as in a country with civil-law legal origin (World Bank, 2002), the standards/laws are expected to be designed and set by the professional organizations, but with noticeable government involvement and/or monitoring (La Porta *et al.*, 1998). High extent of government's intervention in standards/laws setting process is likely to result in more *authorities-oriented* regulations (Choi / Mueller, 1992). World Justice Project (hereinafter: WJP) (2011-2012) formulates the ranking of 'limited government powers' that measures whether any governmental authority is empowered to exercise excessive power. Georgia shares 66th and 67th positions together with Serbia out of the 97 countries' data. The fact that Georgia is a civil-law country, obtaining non-advanced parts in the ranking of 'limited government powers' pushes the author to assume that not *outstandingly high* quality standards/laws are enacted within the country.

Strength of legal enforcement, together with the extent of government involvement in standards/laws setting process, represents a stanchion of the legal framework that needs to addressed. Even if one assumes that high quality standards/laws are enacted within the state, the lingering question is at what extent they are enforced. On the words of Summers (2003), in a country with *appropriately*-functioning institutions contracts should be easily enforced. In the ranking of 'regulatory enforcement', represented by the WJP (2011-2012), Georgia positions on 25th position out of 97 available countries. In terms of 'enforcing contracts' the country places on 30th place out of 185 participants (Doing Business, 2012). The outcomes exhibit that Georgia belongs to relative advanced parts of the rankings, implying the fact that legal enforcement is *quite* strong within the country. However, worth noticing that these rankings cover the general *picture* in the country, whereas, the author argues that the legal enforcement in accounting and auditing sphere is inefficient; the control and sanction systems do not work effectively and the Law of Georgia on Accounting and Auditing is frequently violated within the borders. National Bank of Georgia (NBG), as a major regulatory body, is entitled with an appropriate authority to monitor financial documents and the relevance of audit conclusions. The body is empowered with an authority to implement appropriate sanctions against the violator entrepreneurs. Despite, NBG is authorized for the regulatory enforcement, according to the WBR (2007), the body suffers from effective mechanisms necessary for a decision enforcement. It merely emphasizes on a supervision and prudential regulation, whereas, does not thoroughly check the compliance of reported financial statements with international accounting standards.

The suspect about weak legal enforcement in accounting and audit sphere might be strengthened by leading the following evidence. Although, according to the Law of Georgia on Accounting and Auditing, all JSCs are required to submit annual audited financial statements, from c.a. 1800 JSCs, registered in Georgia, only 480 complied with the requirement in 2005 (WBR, 2007). Moreover, within the framework of this study, was revealed that between the submitted yearly financial statements at the Georgian Stock Exchange, the share of non-audited ones outweigh the share of audited reports. The time for annual reports' submission does not follow to a constant pattern; the majority of the financial statements are submitted within 3 to 8 month time horizon after the fiscal year-end. In some cases, a certain year's financial statement is not disclosed, whereas, nothing is mentioned in the notes of the *next* published financial statement. Quite often, firms do not report semiannual disclosures, albeit, it is required according to the law. In some cases, semiannual reports are submitted after or together with the annual reports. These blatant examples of law violation signal for a weak legal enforcement in accounting and auditing sphere.

2.2.2. Outsider rights

Widely cited accounting literature (La Porta *et al.*, 2000; La Porta *et al.*, 2001) shapes that if outsiders (particularly, minor shareholders) are vulnerable, they become reluctant throughout investment decisions, which in turn, promotes to the existence of more concentrated ownership structures. In case of the existence of highly concentrated ownership structures, corporate insiders are inspired at a lesser extent, to disclose diligently prepared financial statements (La Porta *et al.*, 1998).

To evaluate how secured are shareholders in Georgia, the author emphasizes on its three dimensions such as property-, minority shareholder- and investor rights. In the ranking of 'property rights', introduced by the Global Competitiveness Index (hereinafter: GCI), the country positions on 120th position out of 140 countries as of 2011. In terms of 'protection of minority shareholders' interests', it ranks on 119th place, while in terms of 'the strength of investor protection' Georgia places on 20th position from the same number of surveyed countries (GCI, 2011-2012)[3].

As long as, all the three dimensions operationalize how secured do outsiders feel in the country, *ceteris paribus*, the ranking results should not significantly vary from each other; rather should follow to a *more or less* stabile pattern. Notwithstanding to this, it might be observed that via the third indicator ('the strength of investor protection'), Georgia ranks on much more advanced position in comparison to the first two indicators. Georgia has gained its positions only in the third indicator, while, in terms of 'protection of minority shareholders' interests' and 'property rights', the country ranks as one of the least protected country worldwide. The results seem counterintuitive and cast a shadow to the reliability of outcomes. However, the suspect might be vanished if one follows the logic leaded by Papava (2013), according to which, after 2003, advancement in 'ease of doing business' ranking became Georgian authorities' main political-economic postulate. 'The strength of investor protection' in contrast to 'property rights' and 'protection of minority shareholders' interests', is represented as one of the sub-factor anticipated in the 'ease of doing business' ranking (titled under 'protecting investors'). As a consequence, in terms of investor protection, Georgia belongs to top 20 countries worldwide, but this fact does not precisely portray the *actual* extent of outsider rights. The author argues that, the ranking of investor protection is artificially (due to the desire of advancement in the 'ease of doing' ranking) deviated from the country's overall (natural) situation and does not allow the author to assume that outsiders are *appropriately*-protected within the borders. Even though, in terms of investor protection Georgia belongs to the best 15% of *well*-protected countries, the general picture, operationalized via all the three dimensions, suggest that outsiders (especially minor shareholders) are vulnerable within the country.

2.2.3. Political system

Starting from 2003, Georgian authorities postulated neo-liberal economic policy, targeted towards foreign direct investment (FDI) attraction, which could be eventually reflected in economic development. Within the neo-liberal economic policy, the role of government was reduced to its minimum – limited only by the minimal intervention to formulate the major background and leave the private sector behind the *invisible hand*'s fate (Timm, 2013, 7). As a consequence, the country gained a status of a top reformer on the ease of doing business ranking throughout 2005-2010 (Doing Business, 2012, 6). Defeat of corruption might be considered, *inter alia*, as one of the successful reforms. The mass privatization process of 1993-1997 appeared as a 'fertile soil for corruption' (PaPaVa, 2013, 58). Till 2003, corruption level in Georgia was quite pervasive (PaPaVa, 2013, 58). Afterwards, the government of Georgia declared battle against it, and as a consequence of rigorous attitude, the country was honored as a top reformer country in fighting against corruption throughout 2002-2005 (Anderson / Gray, 2006, 46). WJP (2011-2012) has developed the ranking of 'absence of corruption', measuring government representatives' use of public office for private gain, in 2012, and from 97 countries, Georgia shared 19th, 20th and 21st positions, together with Austria and Estonia.

The August war of 2008 occurred as a turning point for Georgian authorities. Due to August war of 2008 and a consequent unstable political situation, the country failed to maintain the *label* of 'reliable investment region' (Timm, 2013, 2). The government has realized that being in the role of a *viewer*'s presence, and reliance on an *invisible hand*'s fate, was not an efficient way anymore; unstable political situation almost annulated the extent of FDI. Georgian officials declared a new economic-paradigm, under which government's active involvement in the business sector was postulated. Government officials realized that the *state machine* could not alone burden and properly replace the role of *pre-trending* FDI. As a consequence, the government attempted a part of the responsibilities to be delegated over the private sector actors as well. The neo-liberal economic strategy was replaced by a specific form of regulation, under which, in order to coordinate and lead the business in the intended direction, apart from the legal instruments, the authority employed informal tools as well. The country shifted its liberal, market-oriented policy towards a new economic doctrine, characterized with massive regulations.

[3] 'Doing Business' report (Doing Business, 2012) also supplies the ranking of 'protecting investors', where Georgia positions at 19th position from 185 countries worldwide.

The study from Khishtovani and Pirveli (2012, 159-160), in the light of existing *specific Georgian economic doctrine*, examines the case study of the Georgian insurance sector and cautiously explores a new phenomenon such as Corporate Political Responsibility (CPR), prevalent in the country. While the *well*-established term Corporate Social Responsibility (CSR) indicates on a firms' *good will* to implement certain steps, useful for a society, under the CPR, forced (involuntary) corporate steps are deemed from the authors. According to them, throughout the last decade, the development process in Georgia has been accompanied by a (political-economic) phenomenon similar to CSR, but its vectors have been directed towards different actors and types of responsibilities. The authors call this phenomenon CPR and argue that it can be observed when an ordinary private player on the market faces a necessity to complete political-economic activity, usually financially harmful, ruled by the government (Khishtovani / Pirveli, 2012, 159-160).

Implementation of unwilling and unplanned activities most likely leads to the worsened financial performance, as it was a case in the insurance sector. Unexpected costs and/or financial outcomes push insiders to hide non-attractive financial amounts from financial reports. The prevalence of the CPR, presumably, heightens corporate stimulus towards hiding the real current performance and promotes to the existence of *less*-informative accounting numbers.

Political connections promulgate a way to low AQ (Chaney *et al.*, 2011). This is due to two factors; first, firms with political networks more often become a subject of illegal operations. Being politically connected, motivates corporate managers to hide some information from outsiders, to disclose less frequently and less precisely. Second, politically backed enterprises face lower competition, enabling them to attract investors' attention (capital and favor) without supplying them diligently prepared accounting information. The study from Chaney *et al.* (2011) finds that politically connected firms face less competition. Such firms have less pressure from outsider information users to report high quality accounting information. On the words of Bremmer (2009) and Bremmer and Johnston (2009), within the intensively regulated economies, the probability that markets become monopolized and political connections entrench its roots, is higher. The paper from Khishtovani and Pirveli (2012), in assistance to this prediction, reveals that political connections are quite prevalent within the insurance (financial) sector, and summarizes that Georgian firms are inspired to take advantage by being politically backed.

Georgian economic doctrine, manifested after 2008, is characterized with prevalent political connections, CPR (Khishtovani / Pirveli, 2012), elite-corruption (PaPaVa, 2013) and less trustworthy reputation in respect to investment attractiveness. Most likely these facts awake corporate managers' incentives towards hiding the information about its owners as well as about the underlying financial performance. All together strengthen the expectation towards low AQ in the country.

2.2.4. Tax system

Accounting literature (e.g., Atwood *et al.*, 2010) advocates that in countries where the linkage between financial and tax accounting is higher, AQ is expected to be lower. Tax system determines whether firms are financial – or tax accounting oriented. Complicated tax system and *sharp* tax burden may promote to the use of conservative accounting policy that minimizes the income tax. After 2003, Georgian authorities postulated to upgrade business and investment climate in the country. Implementation of market oriented strategy contained changes in the tax system as well. Georgian government aimed to reach private enterprise-driven growth and oriented, inter alia, on the implementation of simple and flat tax rates, and low tax burden (Pocket tax book, 2012, 1). The number of tax types was reduced from 21 in 2005, till 6 starting from 2008. Aggressive tax reforms were performed in order to simplify tax administration and tax policy, which in turn are correlated to the positive national changes especially in transition countries. The tax burden was remarkably lowered. These changes were reflected in global rankings, as well. In 2009, Forbes Magazine ranked Georgia as the "4th least tax-burdened country" worldwide (Forbes, 2009). According to the Georgian National Investment Agency, through these changes the country markedly simplified the regulatory groundwork in the business sector, whereas the tax reform was perceived as one of the impressive successes among post-revolutionary reforms. Tax system framework shows that the country employs liberal tax system, and as a consequence is perceived as one of the least tux-burdened country worldwide, that, *ceteris paribus*, should diminish firms' passion of being tax accounting oriented.

2.3. Market forces

More-developed capital markets, in comparison to *less*-developed ones, together with a higher frequency and volume of trading, are characterized with a higher number of trader investors.

High number of investors, results in a high demand for financial information as investors are one of the most crucial consumers of financial statement information (Dechow / Schrand, 2004). Investors' demand on highly informative financial amounts, in turn, tantalizes managers' incentives to report diligently prepared financial statements (Soderstrom / Sun, 2007, 691).

To evaluate the extent of Georgian capital market development, this study employs capital market size on the one hand (proxied via market capitalization), and market liquidity (proxied via value of stocks traded) on the other. The paper pertains on World Bank dataset[4] and the indicators will be shown in relative (as a percent of GDP[5]) terms. Market capitalization is calculated as the number of outstanding shares times the price per share.

Market capitalization of the Georgian Stock Exchange (hereinafter: GeSE) as of 2011 amounted US$ 800 million, that constituted 5.5% of the corresponding GDP. To draw parallels with the benchmark countries, the average developing country's market capitalization from Europe and Central Asia[6] constitutes to the corresponding GDP's 19.4% in 2011. The average country's indicator from 'Lower middle income' country group amounts 27.9% of the corresponding GDP. And for the EU countries[7], the indicator stands at 37.1%. Throughout 2005-2011, Georgia's ranking of the market capitalization in relative terms (as a percent of GDP) was fluctuating from 116th (in 2007) till 125th (in 2005 and 2011) places out of 127 and 136 and 133 countries, respectively. The ranking suggests that market capitalization of Georgian capital market is considerably small.

For 2011, the value of stocks traded at the GeSE was pathetic, equaling US$ 1.5 million, less than 0.1% of the GDP. Throughout 2005-2011, the market had its maximal liquidity in 2006, when value of stocks traded amounted US$ 95.2 million (1.2% of the GDP)[8]. In Europe and Central Asian developing countries, and in 'lower middle income' countries, the average values of traded stocks in 2011 were US$ 9.1 (5.66% of the GDP) and US$ 17.6 (5.56% of the GDP) billion. In EU, on average, the value of stocks traded was more than 239 billion that constitutes 26.5% of the corresponding average GDP. In terms of the value of traded stocks on the stock exchange (as a percent of GDP) for the year of 2011 Georgia ranked at 131st place out of 133 countries totally; overtook only the two countries, Armenia and Uruguay. The results unequivocally speak that the Georgian capital market is one of the most illicit (small and illiquid) worldwide (at least between the countries, for which market information is available at the World Bank database).

2.4. Accounting regime

Academics perceive that AQ is a function of latitude in accounting standards (e.g., Levitt, 1998). AQ is hypothesized to be higher under the accounting regimes that promote to transparent reporting process and leave little space for subjective judgments (Goncharov / Zimmermann, 2007), as a wide range of allowable accounting treatments provides excessive discretion possibilities for managers in the classification of the assets and obligations (disclosure decision) and in the determination of the extent of accruals (measurement decision) (Elbannan, 2011).

By strong effort of the United States Agency of International Development (USAID), International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB) in 2004, became recognized as applicable standards for Georgia as of 2005 (reg. №11, 6/04/2005). Georgia recognizes the latest version of IFRS (2009) that is translated into Georgian language and is locally adopted. According to the Law of Georgia on Accounting and Auditing, reporting companies (GeSE firms, firms with more than 100 partners or firms licensed by the NBG) are required to prepare audited (non-audited) annual (semiannual) financial statements under IFRS and submit to the NBG. Small and medium sized firms are allowed to use IFRS for SMEs, approved by the IASB.

[4] The rankings base on the World Bank database of 2014; worth mentioning, the number of available countries as well as the lists of different groups of countries (and therefore the ranking positions as well) may considerably vary due to different time period of data collection.
[5] For the definition of GDP, please visit: http://www.worldbank.org/.
[6] Only developing countries are selected from this geographical region.
[7] For the list of countries per benchmark group, please visit: http://www.worldbank.org/.
[8] Worth mentioning that the lion's share in the value of stock traded at the GeSE comes from a one company, the Bank of Georgia.

Although findings around IFRS are massively juxtaposed, its quality is considered to be higher in comparison to most local GAAPs (except of US GAAP), which narrows managers' ability of *sending* financial information users into illusion by earnings discretion (Barth *et al.*, 2005; Barth *et al.*, 2008; Cahan *et al.*, 2009; Daske / Gebhardt, 2006; Ding *et al.*, 2007). However, in the context of Georgia, the applicable version of IFRS does not exactly coincide with the original version of IFRS, recognized by the IASB. That is due to the two facts. First, the translation process of IFRS is not an ongoing process; rather, proceeds once within every five years. Consequently, the changes in the original version of IFRS throughout this period cannot be timely reflected in *Georgian IFRS*. Second, it is difficult to find translators of IFRS with appropriate language (English) and professional (accounting fundamentals) knowledge, reflecting in the version of IFRS contenting noteworthy inconsistencies.

As an evidence, might be leaded findings of the WBR (2007); from six enterprise sector companies examined within the report, only one had non-qualified[9] audit opinion, whereas, the rest 5 audit reports could not precisely assess even fixed costs. According to the WBR (2007), the problem of inconsistency in the *Georgian IFRS* is a considerable factor and might lead to useless financial numbers. Apart from the fact that *Georgian IFRS* is not the same as the original version of IFRS, there exists no compelling reason to expect for informative financial amounts only and only for the sake of existence high quality accounting standards; as the latter, emerges as an effective AQ determinant only and only if other determinants such as institutional settings, market incentives and accounting profession also promote to the existence of high quality accounting information.

In terms of 'the strength of auditing and reporting standards' Georgia places on 88th position out of 142 countries as of 2011 (GCI, 2011-2012). The ranking outcome assists to the above mentioned logic, that, even though, high quality accounting standards (IFRS) are applicable within the country, it does not guarantee the existence of high quality auditing and reporting standards, most probably because of existing inconsistencies (time and conceptual gaps in *Georgian IFRS*) and ineffective enforcement.

2.5. Accounting and audit profession

Lastly, but presumably most importantly, accounting and audit profession is examined in the light of AQ determinant. The author argues that in the context of Georgia accounting and audit profession should be perceived as a main driver of financial reporting. Even if corporate insiders are desired to publish informative accounting numbers, if professional education does not contribute, disclosed accounting information, most likely, will departure from firms' *actual* undergoing performance.

On the words of WBR (2007, 6), estimated number of accountants (including chief accountants) in Georgia is 20000, whereas, Georgian Federation of Professional Accountants and Auditors (GFPAA – accountants' and auditors' main professional organization in the country) counts c.a. 2000 members. The number of GFPAA members in the whole sample is minor. Moreover, from GFPAA members, only 23-24% are certified (WBR, 2007). The share of certified accountants, who fulfilled certification requirements after 2001, when GFPAA strengthened them, is pathetic. The share of certified accountants constitutes to 2.3-2.4% of the whole number of accountants, from which the majority has replied to the GFPAA requirements till 2001. This represents an *alarming* indicator, and raises the question whether Georgian financial statements might be *really* helpful for its outsider users.

Several main violations might be outlined from WBR findings. Georgian financial statements *quite often* are saturated with a 'standard phrasing', implying the fact that some financial statements were filled up with irrelevant information directly copied from international financial statements, illustrative examples (delegated either by the National Securities Commission of Georgia or by auditors, as guidelines) or tax accounting statements, making the reports less useful for outsider users (WBR, 2007).

Companies suffer from recording the transactions that are out of the scope of firms' *normal* operating activities. AQ was relatively higher for firms mostly based on cash flow transactions. The picture changed dramatically when it touched to accruals-based transactions; firms had difficulties with accruals-based disclosures that necessitate the recognition of elements not subject of invoices: recognition of reserves, deferred taxes and asset impairment.

[9] Contrary to the intuition, unqualified audit opinion has positive meaning and qualified – negative. Unqualified audit report status implies for thorough examination of report and indicates to high compliance of international standards, while, qualified audit report status signals for financial statements with significant violations from the applicable standards.

As a consequence, the majority of financial statements is still prepared by the cash-flow basis, similar to the requirements till 2000 (WBR, 2007), whereas, IFRS is heavily based on the use of accruals-based system and requires its deep understanding. These evidences unequivocally establish that the accounting profession in Georgia is of low quality, resulting in low AQ.

The *only* remained way that can promote sophisticated accounting numbers to become informative, is high audit quality. Auditors' ability and motivation of adjusting departures from the *real* current performance can mitigate low quality accounting numbers, shaped by unqualified and/or opportunistic accountants (Dechow *et al.*, 2010). The number of audit firms, able to provide statutory audit, is limited within the country; about 20 audit companies supply rightful audits. Till the July of 2005, c.a. 580 auditors were certified by the Audit Council. From 580 authorized auditors, c.a. 80 were authorized by the GFPAA and the rest by the Audit Council itself. The difference between audit qualities provided by authorized and non-authorized auditors is significant, as well as, gap exists between the AQs of financial statements audited by authorized auditors due to auditors' different: access to resources, experience and technical professionalism. From 14 audit reports, examined by the WBR (2007), 5 were qualified and 9 – unqualified. From 9 unqualified reports, 3 included paragraphs of emphasize. This quite *acceptable* proportion of qualified and unqualified audit statements – indicating relative high quality financial reports, most likely is due to the low audit quality and not due to high quality financial statements. In notes of qualified statements were written the several points why a certain financial statement had a qualified status and each of the point was good enough to label the report as a qualified one. Several audit reports mentioned nothing about the used audit standards, while some of them included copied text from the law. Some of the audit opinions were made for tax accounting statements or did not mention anything about the type of an accounting statement. The evidence indicates to low audit quality.

3. Summarization and Development of Predictions

The second chapter was devoted to the analysis of AQ determinants in the context of Georgia. Country's legal enforcement in accounting and auditing sphere, dissimilar to the national level, is considerably weak. Outsiders, most likely, feel vulnerable themselves. The political situation is unstable, political connections are quite widespread and an interesting phenomenon such as CPR is prevalent. The country is one of the least tax-burdened worldwide. Summarizing the overall picture, most likely institutional landscape does not promote to high AQ. Reshaping in other words, corporate managers are not stressed from external factors such as investors, regulators, laws, etc., to disclose diligently prepared financial statements.

One of the ways that still remains and can encourage managers to report high quality accounting information is the strength of market forces. Corporate managers may not be obliged from institutional factors to spend extra time on financial statement corrections in order to display informative financial amounts, but may voluntarily do so in case they face worthy enough market incentives. Analysis on the extent of Georgian capital market development revealed that it is one of the smallest and most illiquid market worldwide, fixedly positioning at one of the least positions in the rankings. Consequently, it is likely that the stock exchange, with insignificant (almost non-existing) trading volume and frequency, cannot equip firm managers with reporting incentives, and bring a change in AQ either in improving or worsening sides.

Although, high quality accounting standards are applied within the country, the Georgian version of IFRS differs from its original version. The applied standards contain inconsistencies, eliminating the potential effect of high quality accounting standards on the quality of disclosed information.

Finally, accounting and audit profession in Georgia is of outstanding low quality. Whereas, other AQ determinants are less weighty for the Georgia, here the author argues that limited professional knowledge should be considered as the main driver and conditional factor of AQ within the country.

Considering the overall background, the author assumes that Georgian financial statements do not precisely convey firms' *real* undergoing financial performance; basing on the Georgian financial information, outsiders are unable to assess a *real* firm value. As mentioned above, outsiders need the exact picture of firms' current and future performance to evaluate a firm price. Time-series properties of earnings such as earnings persistence and predictability show the extent at which outsiders are able to assess a firm value. Based on the theoretical background, the author predicts that most likely reported earnings in Georgia are poorly persistent and predictable.

Reported accounting information may deviate from the *real* figures either because of intentional or unintentional errors (or a combination of the both). As for the next step, the author aims to shed the light what is a causal factor for the existing gap between reported and *real* accounting numbers; is it a result of intentional or unintentional errors? On the one hand, opportunistic corporate managers intentionally smooth earnings in a way to maximize their benefits. Managers expect benefits by meeting market participants' forecasts, pushing them to *play* with earnings. Earnings smoothness might be a natural outcome of the intentional use of alleged accounting techniques, such as accruals discretion. On the other hand, financial outcomes may unintentionally departure from a firm's *actual* economics; unintentional errors might be a result of technical mistakes, caused by limited accounting profession and low understanding of accounting fundamentals (Richardson *et al.*, 2005).

The author argues that the share of intentional mistakes should be pathetic in the error. This is due to two arguments. First, the capital market is in its incipient stage and cannot awake corporate managers' interest towards intentional earnings manipulation. The number of investors and analysts at the stock exchange is pathetic, making the author to assume that corporate managers neglect market incentives (if any) as long as no benefits should be expected from meeting analysts'/market participants' forecasts. Second, Georgian accountants are limited in the understanding of accounting fundamentals, particularly in the accrual component, which could facilitate corporate managers to manage earnings. Consequent to this, the huge part of the existing gap between reported and *real* financial amounts should appear because of unintentional errors. This suspect might be strengthened by recalling the fact that accounting (as well as auditing) profession within the country is of outstanding low quality that increases the likelihood of existing unintentional (mechanical) mistakes. Consequently, the author predicts that most likely Georgian corporate managers are not intentionally engaged in the use of intentional alleged accounting tactics such as earnings management and the lion's share in the whole error belongs to unintentional mistakes.

So far, it is expected that Georgian corporate managers seem to be incentive-free; they are not incited either to publish representative financial amounts, neither intentionally to sophisticate them. However, even the most incentive-free corporate manager of a profit-maximization oriented company is interested in paying a low income tax. Managers always have a choice between conservative, neutral and aggressive accounting approaches. On the one hand, firms might be pushed from market incentives to employ an aggressive accounting approach and supply attractive (slightly exaggerated than in a reality) financial amounts. On the other hand, firms, for which market incentives are less worthy, might be interested in the use of conservative accounting (to supply slightly depreciated amounts than in a reality) that would facilitate them to pay less income tax. These incentives push managers in juxtaposed directions and eventually they choose the more preponderate one.

Georgian firms disclose financial accounting statements based on IFRS (IFRS for SMEs) and tax accounting statements based on Georgian tax accounting rules. The differences between reporting standards required under IFRS and Georgian tax accounting, is significant (different requirements appear due to fixed asset acquisition, depreciation, repair expenses, lease loss allowance, borrowings, translation of gains and losses, etc.). A simple intuition indicates that firms would prefer to disclose slightly exaggerated results in financial accounting reports (to gain outsiders' favor and capital) and slightly depreciated results in tax accounting reports (to pay less income tax). But managers are limited in simultaneous implementation of the both strategies, as long as a significant difference between the two statements would signal for manipulation or accounting fraud and may trigger regulators' sanctions. Therefore, a puzzle emerges around the choice which report is a priority; is a firm more capital-market oriented or more tax-accounting oriented. After fixing their focus, firms attempt to display the intended amounts in the prior statement and adjust another statement to it.

The Georgian capital market cannot equip managers with worthy incentives. On the other hand, Georgia is one of the least tax-burdened countries worldwide. However, the author argues that in the absence of market incentives, firms would be interested in optimizing income taxes by employing conservative accounting policies. This suspect might be strengthened by the evidence led by the WBR (2007), according to which in some cases, financial statements were filled with the copied amounts from tax accounting statements, indicating the fact that tax accounting outweighs the importance of financial accounting; tax regulation appears as a dominant factor in formulating the financial reports. This is conditioned by a low demand on financial information from outsiders. Limited demand for financial information from the third parties promotes tax accounting to be a dominant statement, though tax-burden is quite *soft*. Firms emphasize on the fulfillment of tax accounting, and *more or less* the same numbers are *drawn* in financial accounting statements.

Therefore, the author predicts that most likely Georgian firms are engaged in the use of conservative accounting policy, that would facilitate them to pay lower income taxes in comparison to aggressive or neutral accounting approaches.

Predictions formulated within this study are subject of future empiricism.

References

Ali, Ashiq and Hwang, Lee-Seok (1999), 'Country-specific factors related to financial reporting and the value relevance of accounting data', Available at SSRN 181279.

Anderson, James Horton and Gray, Cheryl Williamson (2006), Anticorruption in transition 3: who is succeeding... and why?.

Atwood, TJ, Drake, Michael S, and Myers, Linda A (2010), 'Book-tax conformity, earnings persistence and the association between earnings and future cash flows', *Journal of Accounting and Economics*, 50 (1), 111-125.

Ball, Ray and Shivakumar, Lakshmanan (2005), 'Earnings quality in UK private firms: comparative loss recognition timeliness', *Journal of Accounting and Economics*, 39 (1), 83-128.

Ball, Ray, Robin, Ashok, and Wu, Joanna S. (2003), 'Incentives versus standards: properties of accounting income in four East Asian countries', *Journal of Accounting & Economics*, 36 (1-3), 235-271.

Barth, Mary E., Landsman, Wayne R., and Lang, Mark H. (2008), 'International Accounting Standards and Accounting Quality', *Journal of Accounting Research*, 46 (3), 467-498.

Barth, Mary E., Beaver, William H., And, John R. M., and Landsman, Wayne R. (2005), 'Accruals, Accounting-Based Valuation Models, and the Prediction of Equity Values', *Journal of Accounting, Auditing & Finance*, 20 (4), 311-345.

Bartov, Eli, Goldberg, Stephen R, and Kim, Myungsun (2005), 'Comparative value relevance among German, US, and international accounting standards: A German stock market perspective', *Journal of Accounting, Auditing & Finance*, 20 (2), 95-119.

Basu, Sudipta (1997), 'The conservatism principle and the asymmetric timeliness of earnings', *Journal of Accounting and Economics*, 24 (1), 3-37.

Bhattacharya, Utpal, Daouk, Hazem, and Welker, Michael (2003), 'The world price of earnings opacity', The Accounting Review, 78 (3), 641-678.

Biddle, Gary C. and Hilary, Gilles (2006), 'Accounting Quality and Firm-Level Capital Investment', *The Accounting Review*, 81 (5), 963-982.

Bremmer, Ian (2009), 'State Capitalism Comes of Age: The End of the Free Market?', *Foreign Affairs*, 40-55.

Bremmer, Ian and Johnston, Robert (2009), 'The rise and fall of resource nationalism', *Survival*, 51 (2), 149-158.

Burgstahler, David C, Hail, Luzi, and Leuz, Christian (2006), 'The importance of reporting incentives: earnings management in European private and public firms', *The accounting review*, 81 (5), 983-1016.

Cahan, Steven F, Emanuel, David, and Sun, Jerry (2009), 'The effect of earnings quality and country-level institutions on the value relevance of earnings', *Review of Quantitative Finance and Accounting*, 33 (4), 371-391.

Chaney, Paul K, Faccio, Mara, and Parsley, David (2011), 'The quality of accounting information in politically connected firms', *Journal of Accounting and Economics*, 51 (1), 58-76.

Chen, Feng, Hope, Ole-Kristian, Li, Qingyuan, and Wang, Xin (2011), 'Financial reporting quality and investment efficiency of private firms in emerging markets', *The accounting review*, 86 (4), 1255-1288.

Choi, F.D.S. and Mueller, G.G. (1992), International Accounting (New Jersey: Prentice-Hall).

Daske, Holger and Gebhardt, Günther (2006), 'International financial reporting standards and experts' perceptions of disclosure quality', *Abacus*, 42 (3/4), 461-498.

Dechow, Patricia, Ge, Weili, and Schrand, Catherine (2010), 'Understanding earnings quality: A review of the proxies, their determinants and their consequences', *Journal of Accounting and Economics*, 50 (2), 344-401.

Dechow, Patricia M, Sloan, Richard G, and Sweeney, Amy P (1995), 'Detecting earnings management', *Accounting Review*, 193-225.

Dechow, Patricia M. and Schrand, Catherine M. (2004), 'Earnings Quality', *CFA Digest*, 34 (4), 82-85.

Dichev, Ilia D, Graham, John R, Harvey, Campbell R, and Rajgopal, Shivaram (2013), 'A Guide to Earnings Quality', *Available at SSRN 2347428*.

Ding, Yuan, Hope, Ole-Kristian, Jeanjean, Thomas, and Stolowy, Hervé (2007), 'Differences between domestic accounting standards and IAS: Measurement, determinants and implications', *Journal of Accounting and Public Policy*, 26 (1), 1-38.

Doing Business (2012, 2014), Available from: http://www.doingbusiness.org/

Elbannan, Mohamed A (2011), 'Accounting and stock market effects of international accounting standards adoption in an emerging economy', *Review of Quantitative Finance and Accounting*, 36 (2), 207-245.

Freeman, Robert N, Ohlson, James A, and Penman, Stephen H (1982), 'Book rate-of-return and prediction of earnings changes: An empirical investigation', *Journal of Accounting Research*, 20 (2), 639-653.

Global Competitiveness Index (2011-2012), Available from: http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf

Goncharov, Igor and Zimmermann, Jochen (2007), 'The supply of and demand for accounting information', Economics of Transition, 15 (2), 257-283.

Jones, Jennifer J (1991), 'Earnings management during import relief investigations', *Journal of Accounting Research*, 29 (2), 193-228.

Khishtovani, Giorgi and Pirveli, Erekle (2012), 'Corporate Political Responsibility (CPR) and its Impact on Companies' Financial Performance. The Case of the Georgian Insurance Sector', *Economics and Business*, 5 (1), 157-183.

La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrei, and Vishny, Robert W. (1998), 'Law and finance', *Journal of Political Economy*, 106 (6), 1113.

La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrei, and Vishny, Robert (2000), 'Investor protection and corporate governance', *Journal of Financial Economics*, 58 (1–2), 3-27.

La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrej, and Vishny, Robert W (2001), Law and finance (Springer).

Leuz, Christian, Nanda, Dhananjay, and Wysocki, Peter D. (2003), 'Earnings management and investor protection: an international comparison', Journal of Financial Economics, 69 (3), 505-527.

Lev, Baruch (1983), 'Some economic determinants of time-series properties of earnings', *Journal of Accounting and Economics*, 5, 31-48.

Levine, Ross and Zervos, Sara (1996), 'Stock market development and long-run growth', *The World Bank Economic Review*, 10 (2), 323-339.

Levitt, Arthur (1998), 'The importance of high quality accounting standards', *Accounting Horizons*, 12, 79-82.

Lipe, Robert (1990), 'The relation between stock returns and accounting earnings given alternative information', *Accounting Review*, 49-71.

PaPaVa, V (2013), 'Economic Achievements of Postrevolutionary Georgia', *Problems of Economic Transition*, 56 (2), 51-65.

Penman, Stephen H and Zhang, Xiao-Jun (2002), 'Accounting conservatism, the quality of earnings, and stock returns', *The accounting review*, 77 (2), 237-264.

Richardson, Scott A, Sloan, Richard G, Soliman, Mark T, and Tuna, Irem (2005), 'Accrual reliability, earnings persistence and stock prices', *Journal of Accounting and Economics*, 39 (3), 437-485.

Sloan, Richard G (1996), 'Do stock prices fully reflect information in accruals and cash flows about future earnings?', *Accounting Review*, 289-315.

Soderstrom, Naomi S. and Sun, Kevin J. (2007), 'IFRS Adoption and Accounting Quality: A Review', *European Accounting Review*, 16 (4), 675-702.

Summers, Lawrence H (2003), 'Godkin lectures', John F. Kennedy School of Government, Harvard University, 7.

Timm, Christian (2013), 'Economic regulation and state interventions: Georgia's move from neoliberalism to state managed capitalism', (PFH Forschungspapiere/Research Papers, PFH Private Hochschule Göttingen).

Watts, Ross L (2003), 'Conservatism in accounting part I: Explanations and implications', *Accounting Horizons*, 17 (3), 207-221.

World Bank (2007), 'REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Georgia, ACCOUNTING AND AUDITING', 1-26.

World Bank (2002), 'REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC), CORPORATE GOVERNANCE COUNTRY ASSESSMENT, GEORGIA ', 1-19.

World Justice Project (2011-2012), Available from: http://worldjusticeproject.org/.