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Pitfalls in Accounting Standardization: Banking

*Motivation*

There is a very large literature, dating from the 1960s, that discusses the benefits of and constraints on the international harmonization of accounting. The harmonization of accounting standards is in fact being achieved with the widespread adoption of the International Financial Reporting Standards (IFRS). Nevertheless, the idea persists that the introduction of similar accounting standards could fail to harmonize reported information because of the institutional (cultural, legal, tax) differences among countries and the incentives those differences create among the preparers of financial reports. These standards also apply also to financial institutions though they are there frequently modified (at least in practice) by supervisory regulations. Further, not only are most major banks operating in several countries, but the ongoing recession testifies to the international nature of financial markets and risk. Analysts routinely compare financial ratios for banks treating them as if they are comparable, provided they know the regulatory requirements. There is little examination of whether such ratios have the same meaning in terms of measurement. Banking data also reflects supervisory differences but there is increasing agreement on a broad set of supervisory standards. Supervision itself, however, frequently depends on the quality of accounting and one would hope that the introduction of the International Financial Reporting Standards (IFRS) in banking markets will bring about comparable financial reporting by banks and other financial institutions, as well as improved disclosure. In the supervisory context, with the exception of taxation, considerations of the effects of environmental features such as culture, legal framework etc that are prevalent in the accounting literature are rarely mentioned. Given the global nature of banking, and the influence it has on economic activity overall, it would be helpful to know if such confidence in the positive effects of the adoption of similar accounting standards is justified.

A primary risk traditionally faced by commercial banks is credit risk and in order to evaluate how such risk is being realized over time, banks are required to classify their loans according to generally very similar rules in most countries. However, a great deal of judgment is acknowledged to impact such classification. While the use of this judgment has generally been analyzed in the context of earnings management, it is also possible that impaired loans and non-performing loans are not necessarily comparable across countries because of forbearance

on the part of bank managers and their supervisors. Importance has been attached to the introduction of the common standard as a means of improving on international comparability (Matherat, 2005). However, this discussion tends to assume that similar accounting standards will produce similar bank measurements, and does not appear to take account of the accounting debate on the effectiveness of harmonized standards. This paper will examine this question. It surveys the extensive literature that in effect argues that standards that standardize practice would be expected to be the exception rather than the norm. It discusses how standards and supervisory practices impact on one important aspect of bank reporting – loan classification, impaired loans and loan loss provisions.

### *Objectives*

The objective of this article is to examine whether the financial reporting of commercial banks reflects possible differences in culture or incentives even when the banks operate under similar accounting standards, regulation and supervisory oversight. At the base of this question is a consideration of the hypothesis that accounting measurement and disclosure is so influenced by environmental conditions that harmonized standards do not imply harmonized accounting (as examined by Bradshaw and Miller, 2008) An apparently obvious way of doing this would be to compare accounting implementation across countries with the same accounting standards. However, particularly in the case of a supervised industry like banking, differences in accounting measurement may also reflect supervisory differences. It will therefore be important to control for the effects of these differences.

### *Literature Review*

The proliferation of articles in the area of accounting harmonization is so great that Baker and Barbu's 2007 survey of international harmonization was able to discuss over 200 articles but did not reference Ali's 2005 survey of empirical research on the subject. As these articles make clear, within the general area of international harmonization there have been several sub-themes. This review will focus on two. First, I discuss the largely theoretical literature that points out the difficulties in achieving accounting uniformity and comparability because of the several environmental influences under which accounting is implemented and enforced. Second, it will examine some of the empirical findings that either support the notion that similar standards may not achieve harmonization, or suggest that over time, with enforcement, comparable accounting measures and disclosure can be achieved. Since the sector in which these topics will be investigated is banking, the review will also discuss research on the loan accounting of banks and the influences.

Early examinations of the subject started off from the premise that differences in accounting among countries required explanation and developed frameworks for that purpose. Gray

(1988) adopted Hofstede's cultural classification and associated them with four accounting values. Hofstede had developed four (later five) cultural constructs<sup>1</sup>:

- Individualism versus collectivism: the degree to which individuals and societies have loose ties versus those where they are closely integrated;
- Large versus small power distance: the extent to which the less powerful accept and expect that power is unequally distributed;
- Strong versus weak uncertainty avoidance: less tolerance for unstructured situations and the imposition of more rules
- Masculinity versus femininity: preferences for assertiveness, material achievement versus preferences for relationships, modesty
- Long- versus short-term orientation: thrift and perseverance versus respect for tradition, the filling of social obligations

Gray's four accounting values were:

- Professionalism versus statutory control: preference for exercise of individual professional judgment and self-regulation as opposed to prescriptive legal rules
- Uniformity versus flexibility: preference for uniform accounting standards
- Conservatism versus optimism: preference for cautious approach to measurement
- Secrecy versus transparency: preference for confidentiality

Gray associated these with Hofstede's cultural constructs through hypothesizing, for example, that professionalism is positively associated with individualism and negatively with uncertainty avoidance. Gray did not test his hypotheses but Salter and Niswander (1995) did by regressing operationalized versions of Gray's accounting values on Hofstede's first four measures, using data from 29 countries. They found that Gray's hypotheses were generally supported but best at explaining financial reporting practices, as opposed to regulatory structure, and that other factors such as the degree of capital market development and taxation could enhance explanatory power. They infer that accounting harmonization may not improve financial reporting because different countries have different preferences with regard to reporting.

Nobes (1998), citing Douppnik and Salter (1995) who had added institutional factors to Gray's cultural variables to explain differences in financial reporting, argued that the differences in accounting systems arise from the different purposes served by financial reporting. He

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<sup>1</sup> While well-known, widespread use of Hofstede's classification in accounting has been criticized by, for example, Baskerville (2003) who noted that cultures and nations did not equate and that the classification was based on national differences (identified in a survey of IBM employees across countries). Further, she argued that there are limits on cultural quantification, questions about the stability of cultural differences over time, and problems arising from the status of outside observer. As a result, the indices may be misleading when used as explanatory variables for differences in accounting, reflecting mechanisms of social organization, rather than culture.

distinguished countries' cultures by their colonial inheritance and or dominance by another culture, and whether or not their systems are capital market-based or credit -market -based. He argues that culturally independent countries' accounting systems will depend on the whether or not they are capital market based whereas culturally dominated systems would tend to use the inherited systems. Culturally-independent countries' accounting systems would depend on the reporting needs suggested by their financial system. Thus capital-market dominant countries have anglo-saxon accounting systems with more disclosure. The implication of this analysis is not only that the accounting system used depends on the context but that the same system may not be appropriate everywhere.

Riah-Belkaoui (2002) discusses three types of accounting diversity internationally – in practices and principles, in judgments made by accountants and managers and in standard-setting. In addition to the work of Gray and Nobes, he cites Jaggi's (1975) cultural explanation for differences in financial disclosure as arising from environment-varying value orientations of managers and the presence of legal disclosure to enforce reliability. Mueller (1968) considered economic systems rather than culture, attributing differences in practices and principles to cross-country levels of economic development, business complexity, political systems (from centrally planned to market oriented), legal systems (common versus civil law, the existence of trade, anti-trust and similar legislation). Belkaoui's own contribution is a theory about differences in judgment. He attributes these to five relativisms: cognitive (the knowledge structure developed from experience, learning, and prior knowledge used by decision-makers), cultural (model of the world shared by members of society that influences their decision-making), linguistic (sociolinguistic arising from the social role of the individual that affects their interpretation of accounting measures, and linguistic process that affects interpretation and judgment), organizational structure (framework which determines understanding of accounting), and contractual (determines permissible behavior and action), in order of importance. This discussion suggests a strong expectation by Belkaoui and the writers he cites, that individuals across different countries and groups will not only have different accounting conventions, but that judgments by both the preparers and users of accounting data are expected to vary independently of the standards or rules they are using.

There have now been numerous studies examining various aspects of the empirical results of the differences in accounting practice, principle or standards on accounting measurement, financial disclosure etc. and, in addition to (often implicit) tests of the many theories, they introduce new explanations or ways of considering international differences in accounting. Ball, Robin and Wu (2003) consider accounting quality (measured as the timely recognition of economic income, especially loss) in Hong Kong, Malaysia, Singapore and Thailand, in all of which accounting implementation was expected to be (positively) influenced by common (rather than civil) law. Ball et al argue that the focus on standards is incomplete because

financial reporting is sensitive to the incentives of managers and preparers. Those incentives depend on market and political forces, such as government involvement, and the political will to avoid variation. They find evidence that incentives to good quality are decreased in the four countries where loss recognition is less timely because of family influence.

Holthausen (2003) in commenting on Ball et al agrees that financial reporting is affected by country-specific characteristics other than standards. In counter-argument, however, he notes that one cannot be sure of the quality of standards introduced –i.e whether the IAS standards in effect at the time of the Ball et al paper were in fact the current IAS standards and of high enough to overcome institutional features. This argument is in a sense tested by Barth, Landsman and Lang (2008) who argue that the standards framework helps to overcome the institutional factors. They examine whether the adoption of IAS in 21 countries improves the quality of accounting, using the following measures of accounting quality: timely loss recognition (frequency of large negative net income), value relevance (explanatory powers of net income and equity book value for prices) and earnings management (variance of the change in net income). They find that the use of IAS(in comparison with domestic standards) improves accounting quality, arguing that the principles-based nature of the IAS and its effort to constrain alternatives may be sufficient to constrain preparers' opportunistic incentives. They admit, however, that despite attempts to control for other factors, they cannot rule out the possibility that accounting quality also improves as a result of the economic environment or a change in incentives.

Bradshaw and Miller (2003) consider whether harmonizing standards harmonizes accounting practices and find evidence for this in a sample of non-US firms that adopt US GAAP. The firms do adopt practices that are closer to those of US firms, though without fully converging. Regulatory oversight is also associated with more successful implementation. Although using a different metric of accounting value, Hope (2003) also finds evidence that enforcement is important. His model indicates that good enforcement leads to better annual report disclosure which in turn produces better earnings forecasts by company analysts. Pope (2003), in discussing Hope's paper questions whether analyst forecasts are the correct measure of accounting improvement since accounting may be oriented towards different groups (such as creditors) in systems where the equity market is of less importance.

Evidence for both the positive effects of similar standards and the differences resulting from country-specific circumstances is provided by Prather-Kinsey (2006). She examines whether convergence towards International Financial Reporting Standards (IFRS) and US GAAP in S. Africa and Mexico, respectively, improve accounting quality in the dimensions of value relevance (where value relevance is measured as a significant association between the book values of earnings and equity and firm specific stock market return) and timeliness (participants

respond to earnings announcements in a timely fashion). She finds that in both countries actual regulations are converging and that book value of equity /earnings are value relevant, but that in Mexico earnings announcements have no significant information content.

Bushman and Piotroski (2006) consider how institutional structure, viz., legal/ judicial systems, securities laws and political economy create incentives that influence the users and preparers of accounts and, ultimately, the reported accounting numbers. They provide evidence that firms in countries with more state involvement recognize good news (on earnings) faster, and bad news slower, than do more firms in more market-oriented countries. Gul (2006) questions their results because of the use of cross-sectional data which may suffer, inter alia, from correlated omitted variables. He examines instead outcomes in one country, Malaysia, through the effect on auditor behavior of political factors that influence firm incentives, finding evidence to support the effect of incentives on accounting practice. In circumstances where auditors expect worse accounting effort from politically connected firms they are found to increase their fees to compensate for the necessarily increased auditor effort. Lower fees were charged to the companies when they were protected and had less incentive to misrepresent their performance. The paper suggests that the incentives of preparers are an important determinant of the quality of accounts.

Jenkins, Deis, Bedard and Curtis (2008) argue for consideration of culture and governance within accounting firms, suggesting several lines of research. Their paper implies that part of the institutional setting which should also be considered are the auditing and accounting firms who will oversee firms' accounts and on whose work the supervisors and public also rely.

Peng, Tondkar, Smith and Harless (2008) work suggests a more positive role for international standards than does most of the literature cited above. Given that China has been working to converge its accounting standards with IFRS, they consider whether there has been convergence of the accounting practices of listed Chinese firms with IFRS, considering three dimensions – compliance with regulations, consistency of management choices, and comparability of net incomes. Their sample is provided by 79 firms which are required in China to prepare two sets of account, for both the Chinese GAAP and IFRS. They find that convergence has been successful over time (data for 1999 and 2002 are compared), but that compliance with Chinese GAAP remains better. This is positive news for harmonization, but implies that learning may be important. The need for such learning may also explain the differing results of Eccher and Healy (2000) who

Moustafa Leonard, Slaubaugh and Wang (2008), in a theoretical article, suggest however that even if there is perfect harmonization and acceptance of IASB standards, societal culture will still affect how investors process that accounting information. Returning to Hofstede's dimensions, their paper considers how societal constructs (individualism, power distance,

uncertainty avoidance, universalism) influence national standards and investment decision processes. Thus, to differences in preparers, managers, auditors etc. we add differences in investors and the way in which they process the information.

The implications of this literature for the accounting of banks is that bank accounting measures between countries may not have similar meanings and that they may also differ by the culture or incentives of the account preparers. Banks, however, also have to conform to supervisory requirements, the standards for which are generally accepted to be the Basel Core Principles formulated by the Basel Committee on Banking Supervision (see <http://www.bis.org>) which consists of representatives of the central banks or supervisory bodies of 27 industrial and emerging countries. While differences in perspective between the accounting standard setters and supervisors are being recognized (see Borio and Tsatsaronis, 2005), the concern in the accounting literature about the differences in accounting implementation that might remain after the introduction of similar accounting standards, has not been discussed in the banking literature. However, the scope and incentives for earnings management by banks has been discussed at some length and we use this framework to consider how banks' accounting measures may be affected by the institutional setting and incentives of bank management.

A survey of the earnings management literature (Healey and Whalen, 1999) defines it as occurring when managers use judgment in financial reporting and in structuring transactions to alter financial reports to mislead stakeholders about firm performance or to influence outcomes that depend on accounting numbers. They cite many studies specific to the banking industry that find earnings management in banks but note that bank analysts are usually not fooled, though the stock price may be somewhat affected. The area in banking judged most susceptible to earning management is loan loss provisions which depend on judgment of the bank manager.

### *Hypotheses*

The hypothesis is that the judgments made about loan loss accounting by banks depends on the institutional setting of the bank management where institutional setting includes the culture of the bank and the requirements of its head office. Thus we expect the loss classifications, loan loss provisions, and loan charge-offs to differ among banks by the country of origin of the bank. This says nothing about the most accurate way of carrying out such loan loss accounting but is a first step in an investigation of this larger question. If supported, the tests would demonstrate that having a similar accounting framework (and supervision) is not enough to determine banks' loan loss decisions.

## *Methodology*

In an attempt to control for the other influences on bank accounting such as supervisory framework, legal infrastructure, differences in accounting standards, rather than adopting a cross-country test, I will use data from several banks within a single country, pooling time series and cross-sectional bank data. Given the presumption that the IFRS would tend to be the accounting system most apt to enable consistent accounting, the selected jurisdictions are chosen as those which have officially adopted IFRS for the accounting framework of their banks.

The process of accounting for loan losses. In reviewing their credit portfolios, banks must estimate credit losses – a process that requires judgment and hence the opportunity to manage earnings, capital etc. A distinction is usually drawn between large portfolios of small, homogeneous credits which have statistically predictable losses and large loans for which individual estimates are made. At the end of an accounting period, the bank determines probable losses in existing portfolio. It charges loan loss expense as the difference between the loan loss allowance or reserve and estimated losses. The same amount is credited to the loan loss allowance (LLA) as is deducted from gross loans. As individual loans are charged-off, there is a reduction in the LLA. If loans are recovered, the effect on the LLA is net charge-off. Judgments are made on the basis of the guidance provided by the standard.

ie. For loans not held for sale or not acquired impaired.

Loan loss accounting in the United States is governed by US GAAP with which the US regulatory agencies have generally required that banks conform. For loans not held for sale or not acquired impaired, principal sources are Statement of Financial Accounting Standards (SFAS) No. 114, *Accounting by Creditors for Impairment of a loan*, and SFAS No. 5, *Accounting for contingencies*. However, whereas regulators seem to encourage banks to be forward-looking and conservative (Wall and Koch, 2000), these standards require that loan loss decisions are not made on the basis of expectations.<sup>2</sup> Under SFAS 5, an estimated loss can be accrued if the information is available before the financial statement issue that the asset impaired. This should reflect events within reporting period, not in future. i.e. that one or more future events will cause loss, and loss can be reasonably estimated.

For loans individually deemed to be impaired, SFAS 114 defines a loan as impaired when it is probable that the contractual payments will not be received. This standard does not apply to individual small homogeneous loans whose impairment is usually estimated statistically. When the loan is deemed impaired, 114 requires that the loan be written down to the present value of the expected cash flows using the effective interest rate at time of loan. The provision for loan losses (PLL) should be increased by the amount of the write-down.

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<sup>2</sup> The recent crisis and the procyclicality of accounting it demonstrated is leading to a review of of the IFRS.

Nonperforming loans which are the metric most often used when discussing are defined in the US as nonaccrual (i.e not accruing interest, more than 90 days past due and not well collateralized), past due – more than 90 days delinquent. The criteria used to decide on NPLs would be the same as those for impaired loans.

Under IFRS , loans are accounted for under IAS 39, *Financial Instruments: Recognition and Measurement*. It is based on an incurred loss approach that requires objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset. The standard does not permit general provisions unless an attempt is made to estimate loan losses for which a triggering event has occurred.

Estimates of loan losses are determined by management who must satisfy auditors and supervisors that appropriately determined. Much empirical research examined whether managers use their position, discretion to smooth earnings. By increasing LLA through provision (expense) the bank reduces earnings and thus equity. Has been argued and shown that in buoyant times, banks have an incentive to make more provisions and in depressed times to reduce the LLA so as to increase recorded earnings. Hasan and Wall (2004) using a sample of US, Canadian and Japanese firms suggest that LLA is sensitive to preprovision income. Kanagretnam, Lobo and Mathieu (2003) find support for their thesis that banks use loan loss provisioning to smooth their earnings over time. Gebhardt (2008) shows that the accounting rules delay provisioning and have incentives to minimize provisions where earnings are low are equity small.

To test for whether culture, institutions affect banks' loan classification, the paper adopts a basic model used in the earnings management literature and estimates it separately for each bank national, that is, grouping banks by the nationality of their head offices, within a single country, thus controlling for the environment of the banks (other than for those elements determined by ownership). The estimated equation is likely to take the form (from Hasan and Wall, 2004):

$$LLA_{it} = \alpha_1 + \sum \alpha_{jt} N_{jit} + \sum \beta_{kt} D_{kit} + \varepsilon_{it}$$

Where  $LLA_{it}$  = loan loss allowances for bank i at time t

$N_{jit}$  = the jth nondiscretionary determinants of LLA for bank i at time t,

$D_{kit}$  = the kth discretionary determinants of LLA for bank i at time t,

That is, it is hypothesized that loan loss allowances are determined by nondiscretionary components (proxied in Hasan and Wall by nonperforming loans or specific provisions, and total loans or general provisions) and discretionary components earnings and equity (lagged given that higher provisions decrease earnings and equity). The equation would also be estimated for pooled data of the various bank nationalities in order to determine whether differences in the coefficients are significant.

#### *Data Collection*

Data will be drawn from Bankscope which has a relatively extensive series of bank balance sheet and income statement data, with the records of some 16,000 banks across a range of countries. Since the accounting standard used is indicated, one could ensure that the companies in the sample always do use the same accounting standard. It will be necessary to find a good time series for

#### *Validation*

Data from countries other than that used in the test will be adapted to validate the results of the first test.

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