

Accounting and Auditing in Free Economic Zones: Factors for Change and Perspectives of Improvement

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Abstract

The last three decade is marked with the convergence of large scale practices in cross-border capital mobility and benchmarking of international best practices in business, finance and trade. Enhancements in global investment environment and expansion of open economies in number led to a highly competitive global investment climate, in which both developed and developing economies interact to boost economic growth and strengthen stability. Free economic zones became a widespread tool of attracting investment and creating new production capacities, despite structural differences and systemic barriers in regulatory and supervisory procedures. Existing gap in taxation and reporting practices is widening as foreign direct investment is penetrating the business environment of all economies. Therefore, a growing body of need for uniformity and coordination of accounting and auditing policies has become visible and easily identifiable. This article examines the investment policy changes and proposes the recommendations in matching accounting and auditing practices in free economic zones deriving from internationally recognized and prioritized rules.

Keywords: accounting and auditing, free economic zone, foreign direct investment, investment policy.

1.Introduction.

Foreign direct investment is an integral part of an open and effective international economic system and a major catalyst to development (OECD, 2002). Considering the FDI as a key to economic advancement, many developing economies compete to attract as much investment as possible. In or to stimulate the interest of foreign investors, several countries present particular investor-specific privileges in tax, management and customs, while other countries created FDI-privileged economic zones with an absolute provision of preferences. Free economic zones are considered by host countries as magnets for attracting foreign direct investment and are considered as an essential plank of the strategy to promote manufactured exports and achieve long term economic diversification and growth (Hakimian, 2009). Free economic zones serve as a key point of economic development by ensuring the technological modernization, integration and production internationalization. Attracting foreign direct investment by establishment of free economic zones enables aligning the traditional practices with advanced international experience. Transfer of cutting-edge technologies, new production capacity and management skills stimulate business performance, local market saturation and export-oriented production in a host country.

Attracting foreign direct investment brings positive effect and, in one part, it touches to the reforms and adjustments in particular areas. Differences in business structures, legal system and legislative principles, tax and financial control policies may call for changes and improvements. Existing distinguishing features in regulatory and supervisory environments in host and home economies sometimes may lead to investor-state disputes. Therefore, reforms in specific areas, where differences exist, are crucial to create a favorable investment environment. In international practice, accounting system reforms is often seen as a widespread area of investor-oriented systemic changes. Differences in reporting and accounting principles and procedures pose the burden of dual-reporting which create a doubled task of following two diverse accounting systems. Number of cases with investor disputes is increasing as the volume and geographical scope of foreign direct investment is extending at an accelerating pace. In particular, mass disputes with tax avoidance and evasion problems still have remained as a hot issue in free economic and special industrial zones due to different accounting, reporting and auditing procedures. Most policymakers and officials of international organizations are urging governments to adopt full-fledged international accounting standards and to eliminate systemic barriers in order to prevent disputes with investors and to create a common accounting and auditing policy for both local and foreign investors. This article studies the recent developments in international investment policies and provides scientifically-proven further improvement proposals.

2. Literature Review

Accounting system reform is an area of policymaking with high practical value. Wide scientific research in this area is limited in number and scope due to its pure practical manner. Scientific research dedicated to uniform accounting methodologies in free economic zones has been conducted by a bunch of academia. Considering the large economic impact of accounting reform dedicated to investment attraction and concentration purposes, several researchers investigated economywide impact of accounting regulatory changes. Early studies dedicated to uniformity and internationalization of accounting methods were conducted in the 1960s. Harmonization of efforts to create commonly recognized international reporting principles was of Mueller in 1967. Globalization and economic linkages between countries and their cooperation impact was studied by Doupnik and Salter in 1995. In 1998 Nobes investigated privileged relationship and company development under accounting factors, which fully coincides with the current special economic zones support practices through accounting policy regulation.

3. Cross-Country Analysis of Coordination and Reform in Free Economic Zones

A free economic zone is a geographical region that has economic laws more liberal than a country's prevailing economic laws (ICAI, 2010). Creation of free economic zones is increasingly becoming part of national investment policies and may cover broader national economic interests. There is a need to balance regulatory space for governments in applying free economic zone regulations with the interests of investors for transparent and predictable procedures. Concentration of foreign investment in a particular geographic area facilitates modernization and economic shift at regional level. Technology transfer, employment opportunities, managerial improvement and production growth brings extended socio-economic impact. However, enjoying these benefits of foreign direct investment in a free economic zone requires considerable efforts to benchmark the international practices in foreign direct investment attraction, allocation and optimal utilization. Adopting internationally recognized regulation and supervision practices is a prerequisite for dual understanding and recognition of interests of both sides. Therefore, many host economies change their investment policies and overall business environment by conducting reforms derived from long term development strategy and investor's preferences (Table 1).

Table 1. Changes in national investment policies in 2001–2015

Item	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Number of countries that introduced changes	51	43	59	79	77	70	49	40	46	54	51	57	60	41	46
Number of regulatory changes	**97**	**94**	**125**	**164**	**144**	**126**	**79**	**68**	**89**	**116**	**86**	**92**	**88**	**72**	**96**
Liberalization/promotion	85	79	113	142	118	104	58	51	61	77	62	65	64	52	71
Restriction/regulation	2	12	12	20	25	22	19	15	24	33	21	21	21	11	13
Neutral/indeterminate[a]	10	3	-	2	1	-	2	2	4	6	3	6	3	9	12

Source: UNCTAD, 2016.

As shown in Table 1, changes in investment policies are classified into three categories in terms of impact on investment climate: (a) liberalization/promotion, (b) restriction/regulation and (c) neutral/intermediate. However, from the point of objective, they are divided into three types of policy changes: encouragement, restriction and prohibition. In the last decade numerous countries adjusted investment environment by adopting new regulations, offering new incentives and creating investment-oriented zones to promote or facilitate investment. For example, as UNCTAD reported, Uzbekistan established one free economic zone and two special economic zones with a great deal of preferences and opportunities. Nowadays the government is planning to open four special economic zones to attract more foreign investment. Chile enacted a new Framework Law for Foreign Investment and guaranteed access for investors to foreign exchange market, free remittance of capital and earnings and exemption from sales and service tax on imports of capital goods. Indonesia introduced a three-hour licensing process for certain categories of investors. Ukraine enacted a law on licensing of commercial activities. Kazakhstan introduced a one-stop shop in order to enable investors to apply for more than 360 permits and licenses without having to visit various authorities. Moreover, Kazakhstan offered tax incentives and work permits for investors operating in Astana International Financial Centre. South Korea eased employment regulations for foreign investment in the Saemangeum region. Portugal introduced a new regime for the International Business Centre of Madeira to offer a reduced corporate tax rate and withholding tax exemptions on dividend payment. Russian Federation designated the port of Vladivostok and established five areas of priority socio-economic development in the Far Eastern Federal District. The Czech Republic introduced an exemption from real estate tax, expands the range of supported activities and reduces the eligibility requirements for investors. On the other hand, some countries adopted restrictive changes due to economic situation and stability purposes. For example, Australia reformed the foreign investment screening framework significantly to provide stronger enforcement of the rules, a better resourced system and clearer rules for foreign investments. Hungary restricted the purchase by foreigners of privatized plots of state-owned farmland. Poland adopted a law requiring investors to get approval from the Government to buy a stake of 20 per cent or higher in strategic industries such as power generation, chemicals and telecommunication. The Russian Federation lowered the foreign ownership cap in media companies from 50 per cent to 20 per cent.

There are several edges of reforms which touch to the accounting and reporting issues in both direct and collateral manner. Taking the legislative, structural and traditional accounting policies and procedures into account, abovementioned changes in investment policy requires considerable changes in accounting and reporting practices in free economic zones. As many experts found, developing and transition economies are weak in investment and corporate profile of business which bears the burden of rapid and serious adjustments in accounting and auditing practices.

4. Importance of Improving Accounting and Audit Practices in Free Economic Zones: Barriers and Solutions

Accounting theory argues that financial reporting reduces information asymmetry by disclosing relevant and timely information (Sun and Soderstorm, 2007). Asymmetry problem is the main issue that breaks the government-investor relations. Tax regime, sales and marketing activity regulation create differences in accounting and reporting procedures. In international business, accounting asymmetry is often encountered when an enterprise runs reporting activity in two different standards. Host economy's accounting procedures and tax regimes certainly differ from home countries' practices. Sometimes technical faults or operational mistakes may bring serious outcomes which potentially lead to a strict supervision by tax authorities. In developing and transition economies, corporate structure and modern business practices are in development phase. Naturally, accounting practices also keep pace with the progress of economic reforms and face changes in each stage of development. Joint ventures and fully foreign capital-based enterprises feel these difficulties of dual taxation and double reporting issues and regularly attempt to avoid taxes. Concentration of foreign direct investment in a particular area by establishment of investment-dedicated zone is the hotspot of accounting and auditing related issues. Structural differences in regulatory and supervisory environment in tax, accounting, employment and ownership systems require the uniformity in accounting and auditing practices and procedures in order to operate free economic zones.

In a wider horizon, many policymakers and academia support international accounting and auditing standards as the most instrument of uniform, high-quality and clear-cut pattern for reporting for both home and host countries' responsible authorities. Common principles and procedures may create a general platform in reporting and bookkeeping in all enterprises in any free economic zone. Adoption of international accounting and auditing standards may contribute to improving the assessment and collection of taxes on corporate profits. Income determination for accounting purposes is completely differentiated from income determination for tax purposes, and financial statements are prepared in accordance with tax rules. Therefore, there are several obstacles to successful implementation of international accounting and auditing standards in free economic zones (Figure 1).

Figure 1. Key obstacles to adopt international accounting and auditing standards in free economic zones

Source: Astanakulov, 2016.

Clear understanding of international accounting and auditing standards by both governments and foreign investors in free economic zones is the central aspect. Failing such as misunderstanding, confusion or malfunction coordinating requirements, meaning and key principles of standards expand the existing gap further. Recent history of free economic zones shows that transition economies set international accounting standards as a basis when they firstly enforced accounting and auditing related legislative acts. Some developing countries are adopting international accounting standards by selection or only for a specific region, free economic zones in our case. Both options are of positive steps, while other developing ones even do not have any legislative backing to support the functioning of international accounting standards. It should be stressed that as UNCTAD's survey revealed, the largest number of complaints and lawsuits by foreign investors are of free economic zones in these economies.

5. Conclusion

A hotly debated topic of investment capacity improvement issue is achieving the common accounting and reporting principles in free economic zone members. Foreign investors always seek profit, invest in a less risky and more profitable projects. Taxes and other mandatory fees reduces the expected profit and halts the business expansion. Tax avoidance and preference policy can be beneficial for foreign investors in only one condition – unique cores of accounting and reporting principles. Adopting these principles and their relevant elements requires the elimination of abovementioned obstacles. Developing and transition economies have put considerable steps towards aligning international best practices with traditional ones in free economic zones and consequently achieved a reduction in number of tax-related disputes with foreign investors. However, reduction of investor-government tension is not only benefit from adoption of international accounting and auditing practices, as it contributes to enhancing the quality of financial reporting, helping foreign investors evaluate investment prospects and efficiency, supporting business sector development, mobilizing domestic savings, and eventually, stimulating integration into global financial system.

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