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The Benefit of Special Journal in Corporate Financial Reporting Based on International Standard

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Abstract

When countries have announced plans to adopt IFRS in lieu of the standards that had applied previously, they have referred to a number of benefits, mostly to do with equity markets. So it is not surprising that academics have looked to equity markets to assess the extent to which benefits may have materialised. The evidence they have gathered can fairly be characterised as mixed, partly because of differences in samples and the use of a wide range of proxies for the same underlying but unobservable idea. Nonetheless, it seems relatively clear that the shift to IFRS has had many consequences both for the valuation of equities and for equity markets more generally. Although there will always be winners and losers from changes in accounting standards, if only because of their distributive effects, undoubtedly some consequences are regarded by companies and investors as, on balance, beneficial. However, the story is far from complete. Ample scope remains to expand the range of possible benefits that are investigated and to improve, substantially, the methods used to seek them out.

Keywords: accounting standards; analysts; forecasts; benefits of IFRS; cost of capital; globalisation of equity markets; liquidity in equity markets

1. INTRODUCTION

This paper was prepared for presentation at the Information for Better Markets Conference held in London in December 2010 and sponsored by the Institute of Chartered Accountants in England and Wales (ICAEW). The Institute's remit for this paper is captured in the title. I confine my remarks largely to benefits that may be found in financial markets and say little about the costs.

Over the last few years many attempts have been made to assess the extent of benefits of adopting international financial reporting standards in lieu of a country's domestic standards. Typically, researchers have conducted archival studies of capital market effects in countries where consolidated financial reports have been prepared according to IFRS1 for some years. In Europe and Australia, for example, consolidated financial statements prepared under IFRS have been mandatory for listed companies since January 2005. In various countries, such as Germany, listed companies were permitted to adopt IFRS even before they became mandatory. New Zealand and Korea have both followed a similar pattern more recently.

Although the evidence from these studies is not unequivocal, there is little room to doubt important economic benefits can be gained by adopting IFRS. However, the extent of the benefits actually achieved in any one country depends upon many things. They include: the nature of the standards used before the change to IFRS; the credibility of any representation that the financial statements comply with IFRS;2 the presence of legal or other regulatory backing for the standards; and the degree of compliance monitoring and enforcement.

In this paper, I will address five related questions, because the answers to these questions have led me to form the view that the benefits are potentially substantial. First, what is the role of finan- cial accounting standards? Second, when countries have adopted IFRS in particular, what benefits have they sought? Third, what has been their experience? Fourth, what else needs to be in place to gain the greatest benefits from IFRS? Fifth, what does the future hold?

2. LITERATURE REVIEW

A. The role of financial accounting standards

Although the first treatise on accounting methods was printed more than 500 years ago,3 account- ing standards as we know them today are a relatively recent development. They have largely evolved in Western countries with comparatively well-developed capital markets, where fungible ownership rights are traded.

Accounting standards are important in a well-developed capital market because they help resolve a serious agency problem. Broadly speaking, insiders – that is, the firm's controllers, manager-entrepreneurs or 'managers' for short – are better informed than outsiders about their firm's investment opportunities, about how hard they, the managers, will work and the perks they will consume, and how well the firm is doing overall. However, to grow the firm, the man- agers may need access to more capital, which is controlled by others who are outsiders. Being outsiders, they do not know as much as the managers do about the firm's investment opportunities, and they do not know how hard the managers will work or how much they will consume in perks. But they do know that managers will act in their own self-interest, and that from time to time they will take advantage of opportunities to do so. Armed with this knowledge, outsiders will still supply more capital, but only at a premium reflecting the cost to them of not being as well informed as are the managers about the return they can expect from their money. Therein lies the problem: what can managers do to increase their own wealth by reducing the firm's cost of capital, a cost which inevitably reflects the information disadvantage of the financiers?

One thing the managers can do is agree to provide information; to have their performance monitored and their performance reports to outsiders independently verified by professional auditors. Theoretically, having agreed to such a monitoring and reporting process, the managers could then write individual contracts with their financiers, guaranteeing to provide each one with a specially tailored and audited report. But in countries with well-developed capital markets, the number of individual contracts for large corporations would be virtually limitless and their total cost prohibitive. So, where primary and secondary capital markets are important to an economy, uniform accounting and auditing standards will be found because they are a relatively low-cost solution to a serious agency problem.

The bottom line, so to speak, is this. Accounting standards are important if not crucial in a complex financial market because they underpin how capital is allocated and performance is mon- itored and rewarded. Accounting standards have differed from country to country, because of differences across countries in the economic and social forces that have interacted in the past to determine those countries' accounting standards today. Much of the diversity [in accounting standards across countries] results from deeply entrenched differences in legal systems, [in] the relationships between firms and their financiers, [in] income tax systems, [in] inflation rates, [in] historical ties (political and economic), [in] the extent of economic development and [in] the level of community education. (Brown and Clinch 1998, reflecting on reviews by Meek and Saudagaran 1990 and Saudagaran and Meek 1997). Moreover, many of those differences are deep-seated and will not disappear quickly after a country commits to adopting IFRS.

There is a related argument. International accounting standards issued by the IASB are heavily influenced by Anglo-American traditions. They have been framed by reference to developments in countries with a tradition of relatively strong, legal protection of property rights – importantly, against violation of the rights of minority shareholders by controlling shareholders and violation of the rights of shareholders in general by managers. As many have noted, adoption of inter- national accounting standards by countries with other traditions will not, in itself, lead automati- cally to the same outcomes.

B. What benefits have countries sought by adopting IFRS?

As of early December 2010, for domestic listed companies in 154 jurisdictions with a stock exchange, IFRS were required for all companies in 91, IFRS were required only for some companies in 6 and IFRS were permitted but not required in 26. IFRS were not permitted in 31 jurisdictions.4 There are many reasons why countries have adopted IFRS. For some the demand has been driven primarily by the needs of large corporations seeking access to international public equity markets, and large financial intermediaries (institutions) seeking global investment opportunities; sometimes market providers, such as the Australian Securities Exchange, have promoted adoption of IFRS in the hope of deepening their own markets.

3. METHODS

A. Some general comments

More than 100 research papers have dealt with various aspects of the adoption of IFRS.8 Some have been published in scholarly journals and others are still in the form of working papers. Despite the many papers that have been written, it is nonetheless clear that researchers have not yet studied all of the issues that appear to matter to governments. For example, I am unaware of any scholarly papers on changes in regulatory costs following the adoption of IFRS or whether any potential savings are being committed to say increased compliance moni- toring and enforcement in order to secure better overall outcomes. It is also clear that researchers frequently have disagreed on the correct answers to some of the specific research questions that have been addressed.

Many different countries have been studied. Leaving aside 'multi-country' studies, of which there are quite a few, papers I have reviewed recently relate to Australia, Austria, Finland, France, Germany, Greece, Kenya, Malaysia, Netherlands, New Zealand, Norway, the People's Republic of China (PRC), Russia, Switzerland and Turkey. There would be papers on other countries not on this list. Germany has been written about relatively frequently.

Settings that have been studied are (1) voluntary adoption – that is, what IFRS have meant for companies that chose to adopt them when they were permitted to do so, often before they became mandatory at a later date; (2) mandatory adoption – there have been many studies of companies that adopted IFRS when they had no choice, such as listed companies in Europe in 2005;9 and (3) both voluntary and mandatory adoption. When firms are offered the choice, as in Germany before 2005, the probability of voluntarily adopting IFRS increased with the firm’s size, the extent to which it operated internationally and if it was recently listed, and decreased with the concentration of its ownership (Gassen and Sellhorn 2006). The probability has also been found to decline with greater borrowings and the involvement of banks (Gu¨nther et al. 2009), and to increase with the strength of the firm’s commitment to greater transparency (Daske et al. 2009). Katselas (2010) found firms were more likely to be early adopters when they operated within a lower information environment, had a stronger performance record and were domiciled in a country with a higher perception of corruption.

There has been some diversity in the research methods that have been used. A relatively small number of papers have been based on responses to questionnaires. For example, a 2007 survey of executives of German ‘DAX-30′ companies found most believed IFRS would improve the com- parability of financial statements, while the complex nature and cost of adopting IFRS and the

volatility of earnings calculated by applying IFRS were among the most important challenges they faced (Jermakowicz et al. 2007). And an online questionnaire survey of 426 auditors, ana- lysts and users in 27 European countries on the meaning of ‘comparability’ found 67% of them interpreted it as meaning ‘uniformity’, with a strong preference for comparability over time and within the same industry (Cole et al. 2010). There have been a few experimental papers as well. However, most studies have been archival in nature and I will confine my remaining remarks to them.

One study should be mentioned at the outset. It was a study of the benefits expected by stock market investors in the lead up to the mandatory adoption of IFRS. For about 30 years there has been a research tradition of examining market reactions to events that happened before an accounting standard was issued (Noreen and Sepe 1981). The events are chosen because they sig- nalled a substantial change in the odds that a standard eventually would be issued. This method- ology was used to study 16 separate events leading up to the adoption of IFRS in Europe (Armstrong et al. 2010). The sample was drawn from 18 countries, with the UK being represented the most heavily. Overall, event period returns were positive for firms that previously had been characterised by lower quality information and greater information asymmetry, indicating IFRS were expected on balance to benefit their shareholders at least in wealth terms. However, concerns about the effectiveness of the enforcement process may have led to lower equity values of firms in countries with a code law rather than a common law tradition.

B. Eliminating barriers to cross-border investing

As already mentioned, one benefit sought by adopting IFRS is to eliminate barriers to cross- border investing. A common complaint has been that differences in accounting standards have made it more difficult for financial analysts to forecast a firm’s future earnings, so scholars have looked at how IFRS adoption has affected bias, accuracy and disagreement in analysts’ fore- casts, or the number of analysts following a stock and sometimes the volatility in their forecast revisions.

An early study found analysts’ forecasts were more accurate following adoption of IAS and that prior to adoption, the size of the forecast error was greater when the difference between IAS and the domestic accounting standards was also greater (Ashbaugh and Pincus 2001). A much later study also considered changes in the accuracy of analysts’ forecasts for both voluntary and mandatory adopters, as well as for firms that for one reason or another had not adopted IFRS (Horton et al. 2008). It found the largest improvement in forecast accuracy was for manda- tory adopters. Another international study found analysts upgraded their recommendations following the adoption of international accounting standards, consistent with there being signalling and bonding benefits when a firm committed to applying international accounting standards (Karamanou and Nishiotis 2009). An Australian study found that IFRS adoption had resulted in more accurate earnings forecasts where reported goodwill was a larger component of the firm’s assets. Greater accuracy was attributed to the introduction of impairment testing under IFRS in lieu of amortisation, which had been required by Australian accounting standards before 2005 (Chalmers et al. 2010b).

Learning effects are a common finding. They are only to be expected when dealing with complex matters and they extend to users and regulators, as well as preparers. To illustrate, there was substantial non-compliance in the early post-IFRS reports of 50 large Australian

listed companies with respect to impairment testing of goodwill (Carlin et al. 2007). Accounting for goodwill has been a problem area in countries where capitalisation and amortisation of good- will on acquisition had previously been required. Learning also was apparent in a study of ana- lysts’ consensus forecasts for German companies. Forecasts generally were more accurate when based on IFRS rather than German standards, although forecast accuracy was lower in the tran- sition year (Ernstberger et al. 2008).

The removal of barriers to cross-border investing by adopting IFRS can be found in the decisions of international investors. US mutual funds increased their holdings in European com- panies that adopted IFRS relative to their holdings in a control group of companies domiciled in nine non-IFRS-adopting countries (DeFond et al. 2009). For mandatory adopters, the mutual funds increased their holdings only in countries where implementation of IFRS was likely to be more credible. Similarly, IFRS adoption has led to increased stock ownership by international mutual funds, which was attributed to reduced information processing costs and greater comparability of financial statements (Yu 2009). Another recent study used a global ownership database covering more than 144,000 institutional investors from around the world to study changes in equity ownership, following the adoption of IFRS (Florou and Pope 2009). Ownership increased in the adoption year and the next year as well, but only in countries where there was stricter legal enforcement, lower corruption levels and relatively low levels of earnings management.

C. Accounting and disclosure 'quality'

In a number of studies the authors have argued adopting IFRS has brought benefits in the form of higher quality financial statements. Experts regularly rate the quality of disclosures by companies in Austria, Germany and Swit- zerland. One study (Daske and Gebhardt 2006) concluded it had improved under IFRS in these three countries, which in 2004 accounted for more than half the companies known to have adopted IFRS at the time.

Others have focused on measures of 'accounting quality', of which there are many. Examples of so-called lower quality earnings are when the firm has engaged in more income smoothing, or made larger accruals adjustments when calculating net income, or has used less conservative accounting practices (Kholis et al. 2020). One study concluded adoption of IFRS did not constrain earnings manage- ment compared to German GAAP; companies that did adopt IFRS subsequently engaged in more income smoothing, not less, although the effect was not as apparent among firms with a Big 4 auditor (Van Tendeloo and Vanstraelen 2005). Similarly, it was found that accounting quality, indicated by several proxies for the degree of earnings management, did not improve in Germany following adoption of IFRS (Goncharov and Zimmermann 2006). Yet another study, based on a sample of over 1600 companies in 21 countries where IFRS were adopted in 2005, reported firms exhibited more income smoothing, less conservatism in their accruals and less timely loss recognition (as in Basu 1997) after adopting IFRS (Ahmed et al. 2010). However, others have found differently. One employed 15 proxies to measure earnings management in 17 European countries (Aussenegg et al. 2008). There was less earnings management post- adoption in Central European countries, although there was no change for companies in the UK, Ireland or Northern Europe. Another study found accounting quality improved after compa- nies adopted IFRS, for a sample drawn from 21 countries, in that there was less earnings manage- ment and more timely loss recognition (Barth et al. 2008).

One of the more recent studies used five indicators to compare changes in accounting quality of companies in 15 European countries following adoption of IFRS, again with mixed results (Chen et al. 2010). On the one hand, 'quality' appeared to increase, since the absolute size of dis- cretionary accruals declined and there appeared to be less managing of earnings towards targets.

On the other hand, 'quality' appeared to decline, since earnings smoothing evidently increased while losses were recognised in a less timely fashion. Two other measures of the 'quality' of earnings are their time series persistence and their ability to predict future cash flows. IFRS and domestic GAAP earnings have been found to be indistinguishable according to these two measures (Atwood et al. 2011). In brief, it is obvious that not all studies have reached the same conclusion. Different samples and different proxies for 'quality' must explain much of the confusion in the literature.

D. An aside on the influence of standards relative to managers' incentives

It has been argued that managers' incentives dominate standards in determining accounting quality. The extent of earnings management and timely loss recognition has been measured before and after adoption of IFRS by German companies. The companies were classified in two categories, the early (voluntary) adopters and those that 'resisted' adoption (that is, they chose not to adopt IFRS until they were required to do so in 2005). Improvements occurred only among the former (Christensen et al. 2008). But when propensity matching was used to control for differences in German firms' incentives to adopt IFRS early, significant improvements were found in the earnings quality of voluntary adopters relative to their propensity-matched counterparts in that the earnings of the IFRS-adopters were more persistent, more predictable and more conditionally conservative (Gassen and Sellhorn 2006).

Relatively few studies have focused on Asian economies. An exception is one that measured earnings quality by Basu-type timeliness (Ball et al. 2003). Reporting incentives in Hong Kong, Malaysia, Singapore and Thailand were said to have much in common with code law countries, although institutional characteristics were consistent with reduced demand for higher quality reports (Muda et al., 2020). It was then argued that preparers' incentives (primarily the incentives of the boards of the reporting companies) can be a powerful differentiating characteristic when comparing 'quality' across countries.

Finally, it has been claimed that the capital market environment and the economic cycle during the adoption period are more powerful explanations for differences in earnings quality indicators than voluntary or mandatory adoption of IFRS (Gu¨nther et al. 2009). The implication is that managers' incentives, as reflected in the voluntary adoption of IFRS, do not obviously dominate accounting standards as far as earnings quality is concerned.

E. Comparability

In the context of accounting standards, comparability refers to the ability to use accounting data to draw valid inferences about similarities and differences both between entities and for the same entity over time; improved comparability of financial statements is another potential benefit of adopting IFRS. However, IFRS do allow some choice among accounting policies. So it is not sur- prising that a review of 16 accounting policies employed by 'blue chip' companies in the largest five stock markets that used IFRS found national practices pre-dating IFRS tended to be preserved post-IFRS where they were allowed. This has led to 'national patterns of accounting' that may limit comparability (Kvaal and Nobes 2010). In particular, changes in the comparability of accounting numbers in Germany and Italy, both code law countries, have been studied (Cascino and Gassen 2010). While comparability may have improved post-IFRS, incentives at country, regional and firm levels have remained influential.

Diversity in accounting practices can be expected to increase the dispersion of accounting measurements of the same underlying event. One study, based on a sample of 81,560 firm- years drawn from EU and Australian companies over the period 1994 – 2004 and in 2006.

4. RESULTS DAN DISCUSSION

4.1. Result

First is the need for effective enforcement. Enforcement is an essential component of the insti- tutional fabric for securing compliance and the benefits from adopting IFRS, although there may be some scope for variations in the structure of the enforcement body and its methods of operation (Brown and Tarca 2007).

Important interactions have been found between enforcement and improvements in analysts' forecast accuracy and dispersion (Byard et al. 2010), and in financial reporting quality, after adopting IFRS. One comprehensive study of the latter (Cai et al. 2008) was based on more than 100,000 firm-year observations drawn from 32 countries between 2000 and 2006 and employed a country-level enforcement index (Hope et al. 2006). The extent of earnings manage- ment was found to have been declining over time and it was less prevalent in countries with a stronger enforcement process. Another large-scale study (Houqe et al. 2010) used country- level ratings obtained from the 2008 edition of The Financial Development Report of the World Economic Forum. Enforcement measures covered the enforcement of securities law and accounting standards, judicial independence and the protection of the rights of minority share- holders. The sample comprised more than 104,000 firm-year observations from 46 countries between 1998 and 2007. It found accounting earnings quality is greater in countries with stronger investor protection when they have adopted IFRS as well.

Improvements in 2005 to enforcement actions that accompanied the mandatory adoption of IFRS have also been the subject of study. For example, German firms subject to enforcement actions have tended to be less profitable, to have greater incentives to manage earnings and to have poorer governance arrangements (Ernstberger et al. 2010). Returns, trading volumes and stock market bid– ask spreads around the announcement of an infringement all indicated that the threat of being subject to an enforcement action can be an effective deterrent.

Second, with respect to education and training, there is a big role for the universities and also for accounting firms and professional bodies in equipping university graduates for a career in accounting, in developing well-trained teachers and researchers, and in catering for the pro- fessional development needs of practitioners, whether they are employed as preparers, users, audi- tors or regulators. A study of compliance with IFRS by companies in the Gulf region found that the degree of compliance improves with a country's willingness to invest in the professional development of those responsible for compliance monitoring and when enforcement actions are taken against those who do not comply (Al-Shammari et al. 2007).

I do not need to say anything much about the importance of the independent auditor in estab- lishing the credibility and reliability of accounting reports, and in verifying the correctness of the statement that a company's financial statements comply with IFRS. Auditor independence is crucial, as is 'auditing the auditors'. Finally, there is a big role for legal protection of the rights of outsiders relative to insiders, to put it simply, and for accounting standards to have the force of law.

4.2. DISCUSSION

As Niels Bohr is reported to have once said, 'Prediction is very difficult, especially if it's about the future.'11 Nonetheless there are some things we can predict reasonably confidently about the future of international accounting standards. There is a widely held view that entrenched differences in socio-economic conditions cause substantial differences in accounting practices across countries and these differences cannot be removed overnight. Even when IFRS are required by law, there will be 'many a slip 'twixt the cup and the lip', to quote an old English proverb. Moreover, nations have boundaries; and questions of sovereignty over the law and its derivatives, such as accounting standards, will not go away. Consequently, there will be differences in the degree of compliance for years to come and the potential benefits of a common set of accounting standards may never be realised in full.

There is another view. Sovereignty has its limits too. Countries will depend even more heavily on integrated markets and international trade for the well-being of their people. In time, the finan- cial crisis of 2007 – 2008 may well be seen as little more than a painful hiccup,12 with much of the initial concern about the usage of fair values eventually dissipating. (It is not at all obvious, of course, that the shortcomings of fair value accounting lay entirely at the door of the standard- setters: Laux and Leuz 2009.) Be that as it may, systemic financial risk and the stability of the world's financial markets will be a growing challenge and closer cooperation among nations will be needed. There are major benefits to speaking the same financial language in an increas- ingly integrated world and IFRS is part of that dialogue.

So, what of the future? Despite some troubling differences, for example, in relation to accounting for research and development activities, convergence of IFRS and US GAAP will continue. Eventually, it may be the case that the IASB will emerge as the leading standard- setting body, if only for geo-political reasons. In any event, there will be more IFRS adoptions, although some countries will continue to allow local departures. And there will be strong pressure to adopt the standards as soon as practicable after they are issued by the IASB, despite the ‘crack- ing pace’ sometimes set by standard-setters.

We researchers will always be challenged. We can always do with better theory; for example, can we predict better what will change in our economies as a result of the adoption of uniform financial accounting standards? We can always look for better models, better proxies and better estimators. There is a need for a sharper focus on differences across countries in the regulatory underpinnings of IFRS, in compliance monitoring, in enforcement, and in an area I have not discussed in any detail, namely, the importance of high quality cor- porate governance at both country and firm levels. That said, here is my list of directions that might be taken in future research into the benefits of adopting IFRS. They are in no particular order.

a. Range of benefits. Many potential benefits from adopting IFRS are still to be researched. A few examples are the influence of IFRS on professional skills, education, labour market mobility, business opportunities for financial institutions and professional accounting firms, and better out- comes resulting from improved compliance monitoring and enforcement of IFRS. There are also major internal benefits to multinational companies with subsidiaries operating in different countries. The benefits to debt markets are also under-researched.13
b. Benefits vs. costs. Many if not most capital markets-based studies – for example, studies of the relationship between stock price, earnings and book value of equity – reflect benefits net of costs. Other studies, for example, studies of analyst forecast accuracy, may reflect mainly the benefits. I expect the commercial and regulatory communities would be interested to know the principal drivers of the costs separately from the benefits, their economic importance and how they vary over time. I also expect some researchers will attempt to satisfy that interest.
c. Learning. When faced by complicated change in the environment, people do not fully adjust their behaviour overnight. In the case of IFRS adoption, standard-setters, preparers and those who issue guidance to them, auditors, analysts and other users of financial statements, and regulators, can all take a significant amount of time to adapt. Moreover, IFRS are not static: new standards are being introduced and existing standards revised frequently. One implication is that early results may no longer hold. Another is that researchers, especially users of panel data, would do well to accom- modate the standard-setters’ ‘shocks’ to IFRS and subsequent learning, over time, by affected parties.
d. Differences between ‘previous-GAAP’ and IFRS. It is reasonable to expect those who seek to demonstrate the benefits of adopting IFRS to condition their estimates on the difference IFRS make to the accounting numbers. More can be done to develop and calibrate models that explain these differences (e.g. by employing data available for the transition year), to use the models to predict the differences for sample companies in other years and to incorporate those differences in the analysis.
e. Variables of interest. There is considerable scope for refining key variables. For instance, although there are exceptions (e.g. Katselas 2010), studies often use the ‘as observed’ bid– ask spread as if it were a reliable indicator of the cost of adverse selection. Another example is measures of the cost of capital, of which there is a daunting array. Additional examples are measures of ‘timeliness’ and ‘accounting quality’. Much more can be done to refine these and other measures and to validate them in related settings, as a means of increasing our confidence in the correctness of the con- clusions reached in studies that employ them.
f. Corporate governance. Corporate governance at country and firm levels is believed to have an important influence on many aspects of the firm’s behaviour such as its disclosure policy, transpar- ency, financial policy, the quality of its accounting numbers, choice of auditor and so forth; and to influence the properties of analysts’ forecasts, as well as its cost of capital (Brown et al. 2011). While the literature on corporate governance is also yet to overcome some major hurdles (for example, how to accommodate enforcement), we can expect a tighter integration between the two literatures in the years ahead and a move away from single equation models of the type found in so many accounting studies.

5. CONCLUTION

To conclude, let me return to the question in the title to this paper: ‘What are the benefits?’ The answer is clear in my own mind: ‘The potential benefits to a country and its people from adopting international financial reporting standards are manifest in different ways. Collectively, they can be very large indeed although it takes more than just adopting IFRS to realise them.’However, the evidence to support that view is far from complete.

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