



The Economic Effects of IFRS Adoption

Investigating the Expected Benefits

By Barry Jay Epstein

The SEC has waived reconciliation to U.S. GAAP for foreign private issuers (that is, foreign companies that register in the United States) that prepare financial statements, filed on Form 20-F, in full compliance with International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB). It has proposed a road map that—if followed by the new SEC leadership—could mandate adoption of IFRS beginning in 2014. Taken together with the rapidly growing pace of IFRS adoption by other influential countries (e.g., Canada, which will officially switch from Canadian GAAP—a near-twin of U.S. GAAP—to IFRS by 2011), this por-

tends a potential worldwide embrace of IFRS over the next few years. The highly touted U.S. GAAP-IFRS convergence project, while still moving forward, will soon be eclipsed by these other events. While it is by no means certain, if the SEC road map comes to fruition, it will have consequences that will be felt by accountants in the United States.

The advantages of a single set of financial reporting standards are manifest, particularly as internationalization of business activity becomes the norm. In particular, having uniform, high-quality standards has been extolled as fostering international business relationships, with the goal being the facilitation of cross-border

capital flows and the lowering of the cost of capital—the expected result of the anticipated reduction of perceived accounting risk. The actual record has been somewhat mixed, although over time, these benefits will accrue to many, if not most, participants, with little or no offsetting harm to any other capital market participants.

There are economic arguments to be made for the adoption of a single set of uniform financial reporting standards—for which there is only one viable candidate, namely IFRS. For various reasons, the FASB's role as the putative international standards setter is no longer tenable. IFRS is widely viewed as being, at minimum, of very good quality and adequate for the task. The next battleground will be over the quality of auditing and enforcement applied to IFRS-based financial statements across the diverse jurisdictions where IFRS has nominally been adopted, but where it may or may not have been fully and properly implemented by financial statement preparers.

Background

It has long been an article of faith that uniform financial reporting standards will result in a lowered cost of capital, which all agree is a desirable objective. In mechanical terms, a lower cost of capital results when investors are willing to accept lower returns (interest on debt, dividends, and capital appreciation on equity) from their investments in corporate securities. Investors are, theoretically, willing to accept lowered returns when the perceived riskiness of their investments is reduced. Riskiness is a function of many factors—most of which are not accounting-related—but accounting risk is definitely a relevant concern. Accounting risk refers to the risk in investing that derives from difficulties in understanding the accounting principles being applied by the reporting entity, and the possibility that financial reporting standards may not be uniformly adhered to.

Historically, many nations mandated their own local set of financial reporting rules, meaning that U.S. investors who wished to invest in foreign countries needed to either achieve some level of fluency in those nations' versions of GAAP, rely on others (such as investment advisors), or simply roll the dice. Additionally, foreign companies are subject to varying degrees of financial reporting supervision, which in

many instances is far below that provided by the SEC for domestic registrants. If foreign companies were registered on U.S. exchanges and, therefore, had to file with the SEC, they were required to reconcile from their respective national GAAP to U.S. GAAP, layering concerns about another variable—namely, the quality of the reconciliation process.

Over time, many nations have either conformed their national GAAP to IFRS (e.g., Australia) or, in a few cases (e.g., Germany), have permitted financial reporting for consolidation purposes in accordance with U.S. GAAP. However, nations adopting or permitting the use of IFRS (the standards developed by the IASB and its predecessor, the IASC, since 1973) have sometimes mandated or allowed various flavors of IFRS to be used, which provided only limited comfort to users and failed to completely eliminate accounting risk.

IFRS gained much wider acceptance when the European Union imposed IFRS-based reporting on all publicly held EU-based companies (for consolidated financial statements only, thus far) beginning in 2005. Due to the well-publicized “carve-outs” it legislated, however, this did not result in full IFRS adoption. Apart from a limited waiver granted by the SEC, this means that foreign private issuers using “EU-endorsed IFRS” will not be granted exemption from the SEC's reconciliation requirements, a fact that may cause the European Union to reconsider the wisdom of the carve-out strategy.

In 2002, the IASB and the FASB agreed on a strategy of convergence of their respective standards (reiterated and formalized in 2006), and many revisions to both U.S. GAAP and IFRS have since been adopted in pursuit of this seemingly useful strategic initiative. The goal, as stated, was to bring the two sets of standards so closely into alignment—even if not identical—that users would find the differences essentially irrelevant to investing and other decisions. This process continues (e.g., IFRS adoption of FASB-style requirements for interest capitalization and segment reporting, FASB adoption of IFRS-based rules for correction of errors and nonmonetary exchanges), but now will probably be subjugated to a much more fundamental

change: the expected U.S. move to allow, and then possibly mandate, financial reporting under IFRS.

Financial Reporting Quality

The historical U.S.-based opposition to permitting IFRS-based financial reporting has generally been ascribed to the concern that international standards were not of the same quality as U.S. GAAP. To allay such concerns, the former IASC evolved into the IASB in 2001, and adopted due process essentially identical to that of the FASB [although without the funding advantage that the Sarbanes-Oxley Act (SOX) bestowed upon the FASB]. There appears to have been broad recognition that the IASB has greatly improved the quality of existing standards, and has closely cooperated with the FASB in developing important new standards (e.g., the application of the acquisition method of accounting for business combinations).

The IASB still prefers less comprehensively prescribed guidance (using a principles-based approach) than does the FASB (using a rules-based approach)—although claims that the detailed prescriptions under U.S. GAAP caused or contributed to the epidemic of financial reporting frauds in the United States in the late 1990s and early 2000s have been largely debunked. The SOX-directed study by the SEC, in fact, supported the need for fairly extensive bodies of rules, based on solid principles—a composite solution the SEC named the “objectives-based” approach. The more important finding was that the inclusion of multiple exceptions to general requirements created ambiguity in financial reporting standards that, when coupled with auditors' reluctance to confront client demands in the absence of specific, inflexible requirements, was most often the culprit behind financial reporting abuse.

It has also been noted that, given the great and growing complexity of financial and other transactions, financial reporting needs cannot be met by financial statements alone. Information outside the financial statements—beginning with management discussion and analysis-type narratives—will be forced to assume a greater role in the larger body of information presented to investors and other interested parties. This has long been advocated by writers such as Paul B. W. Miller and Paul R.

Bahnsen, whose *Quality Financial Reporting* (McGraw-Hill 2002) offers one such comprehensive proposal, and the consortium working on Enhanced Business Reporting (EBR), which has produced frameworks for both public and private reporting entities. The author recognizes such a need, although this article is focused only on the GAAP/IFRS implications for the quality and effectiveness of the basic financial statements and related informative disclosures (i.e., footnotes).

The currently popular watchword for financial reporting—transparency—means the user can “see through” the financial statements to the underlying economic substance of the reporting entity—its financial position and results of operations, in particular. It has long been recognized that financial statement preparers may be motivated to defer or disguise the recognition of losses, with obvious misleading implications for decision making by investors. National GAAPs in “code law” countries were more frequently accused of abusing transparency due to legally imposed techniques such as statutory reserves, but failures even under “common law” national GAAPs have also been widely cited. Closely related is the concept of timeliness, defined as the extent to which current-period accounting income incorporates current-period economic income. Ideally, financial reporting conveys accurate information about the reporting entity’s real economic performance and position, but even these terms are subject to debate (ergo, the long-standing—albeit now officially forsaken—use of conservatism as a fundamental accounting construct, even though this almost always resulted in income measurement asymmetries).

There is now general agreement that IFRS-based financial reporting will ensure reasonable accomplishment of financial statement objectives (although not necessarily superior to the accomplishment of these same objectives under U.S. GAAP). The question is: Will universal adoption of IFRS also result in reduced cost of capital (and other benefits) for reporting entities?

Liquidity and Financial Reporting

Accounting was invented as a formalized method to record and report upon economic activities of business and other enterprises. As capital market participants

become more assured that the reporting entities’ financial statements accurately report their respective economic positions and results of operations, there should be more liquid markets for those entities’ securities, as well as reduced costs of capital. Liquidity refers to the ease of selling assets (e.g., investment securities), as evidenced by lower transaction costs and narrower bid-ask spreads. Because transaction costs add nothing to the intrinsic value of the assets transferred, lower costs, when warranted, improve the investment returns to be realized.

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In the author’s view, the need to master multiple sets of financial reporting requirements can be analogized to incurring transaction costs. If an investor can take a position in a domestic company reporting under GAAP, it may be preferable to making an alternative investment in a company reporting under IFRS, simply because of that investor’s clearer understanding of the domestic company’s financial statements. In order to confidently invest in the latter, the rational investor (and in economic theory, there is no other kind of investor) would have to devote some attention to becoming conversant, if not fluent, in the foreign GAAP. Whatever time and effort would be required to do so would be a “transaction cost” incurred in making that investment, which would add nothing to the expected return. Reducing or eliminat-

ing that transaction cost would, all other things being equal, encourage a potential investor to consider the alternative opportunity, which would facilitate international capital flows, meaning that capital would flow to the optimum investment opportunities regardless of geography, thereby maximizing overall economic benefits.

Cost of capital is a commonly invoked concept, but in practice is often difficult to measure. At its simplest, cost of capital is the price demanded as an expected return by investors. From determining the hurdle rate for investment projects to influencing the composition of an enterprise’s capital structure, the cost of capital influences the operations of a business and its subsequent profitability.

Because cost of capital is correlated to the perceived riskiness of the investment, reducing riskiness should result in lowered cost of capital. Risk, in turn, is the sum of many factors (ranging from risk of technological obsolescence to risk of expropriation). One element is the risk that the financial statements do not faithfully represent what they purport to show—namely, the reporting entity’s economic performance.

One study modeled the impact of information attributes on the cost of capital, finding an important role for the accuracy of accounting information (David Easley and Maureen O’Hara, “Information and the Cost of Capital,” *The Journal of Finance*, vol. 59, issue 4, August 2004). Precise accounting information directly lowers a company’s cost of capital because it reduces the riskiness of the asset to be acquired. Because information affects asset prices, the quantity and quality of that information is very relevant for asset-price behavior. An important implication of this research is that companies can influence their cost of capital by affecting the precision and quantity of information available to investors. This can be achieved through the selection of its accounting standards, as well as through corporate disclosure practices.

In the author’s view, accounting risk can be further analyzed as the product of several possible underlying phenomena. One is the risk that the accounting principles employed are not actually intended or designed to measure real economic constructs. For example, historical cost-based accounting for long-lived assets does not even pretend to measure the economic value of those assets, if economic

value is defined as related to the future earnings or cash flows to be generated by the use of said assets. (Of course, impairment recognition standards—such as SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, and IAS 36, *Impairment of Assets*—are intended to impose an economic assessment on the downside, but do not capture upside changes in value.) On the other hand, many critics claim that fair value accounting for long-lived assets may suffer from measurement complexities, which also may contribute to the failure of financial statements to convey valid economic assessments.

Another aspect of accounting risk arises from the inability of users to process the information. If measurements and disclosures are of such complexity that the hypothetical “typical” investor cannot digest this information when making a decision, she will perceive greater risk and, accordingly, should demand higher expected returns—which is another way of saying the reporting entity will have a higher cost of capital. Arguably, a move toward more transparent and uniformly applied international accounting standards would help mitigate this aspect of accounting risk.

There is also the risk based not on the underlying financial reporting principles, but on the confidence that the reporting entity has faithfully applied them. This depends upon investors’ belief in the regulatory regime overseeing financial reporting (e.g., SEC enforcement), and on the auditors’ technical capabilities and willingness to enforce GAAP or IFRS rules. While auditors’ honesty is rarely challenged (although several high-profile frauds, such as Parmalat, have involved criminality on the part of auditors), the reluctance to confront clients opting for aggressive interpretations of accounting standards is more widely acknowledged.

Clearly, reducing accounting risk should have salutary effects on the cost of capital. A number of academic studies have investigated this premise, with overall positive, if modest, findings, although there is not unanimous support for this proposition. Several of these studies are discussed in greater detail below.

IFRS Adoption and Cost of Capital

Because direct measurements of cost of capital are not a simple matter, researchers

have employed a range of indirect and ingenious approaches to investigating whether the adoption of IFRS does in fact lower this cost. A few general observations are warranted before addressing the central topic.

First, national GAAPs have commonly been categorized as being designed for either code-law or common-law traditions, with most continental European GAAPs and Japanese GAAP being examples of the former, and U.S. GAAP, U.K. GAAP, and IFRS (which was largely derived from U.S. and U.K. GAAP) being typical of the latter. It is inevitable that countries moving from code-law-based GAAP to IFRS will experience a more substantial change in financial reporting standards than will those moving from common-law-based GAAP to IFRS. Previous research has found that properties of financial reporting do vary materially between these two traditions, specifically in that there is greater timeliness and conservatism under common-law regimes (Ray Ball, S.P. Kothari, and Ashok Robin, “The Effect of International Institutional Factors on Properties of Accounting Earnings,” *Journal of Accounting and Economics*, 29, 2000).

Second, investor confidence in a given entity’s financial reporting depends on more than the financial reporting standards it claims to subscribe to. In particular, the perceived vigor of enforcement over financial reporting plays a substantial role, since poor enforcement of adherence to national GAAP bodes ill for enforcement of a newly imposed IFRS. For that reason, some research finds that certain reporting entities based in jurisdictions with weak enforcement—or entities previously known for poor adherence to standards—have sought to quickly adopt IFRS when so permitted, hoping perhaps to gain from the association with the “brand name” identified with reporting quality [Ray Ball, “International Financial Reporting Standards (IFRS): Pros and Cons for Investors,” *Accounting and Business Research: International Accounting Policy Forum*, 2006].

Third, in those jurisdictions where this was possible, entities voluntarily adopting IFRS (or U.S. GAAP, for that matter) before it was mandated have been widely viewed as being more committed to transparent and higher quality financial

reporting (Holger Daske, Luzi Hail, Christian Leuz, and Rodrigo S. Verdi, “Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences,” working paper, University of Chicago Graduate School of Business, August 2008). This phenomenon is explained by “signaling theory,” as set forth by A. Michael Spence and others (“Job Market Signaling,” *The Quarterly Journal of Economics*, 87, August 1973). Such behavior may be viewed positively and, as a consequence, the effects from IFRS adoption may be more measurable for these entities.

Finally, a number of foreign entities (approximately 1,000) have elected to list securities in the United States and register with the SEC, filing Forms 20-F and (historically) reconciling net income and stockholders’ equity reported under national GAAP or IFRS to U.S. GAAP. Many of these companies hail from jurisdictions having fewer investor protections (commonly defined as including the ability to hold directors accountable and to engage in the kinds of class action, shareholder derivative, or other lawsuits that are a hallmark of the U.S. system). By listing in the United States, these companies have willingly exposed themselves to the risk of lawsuits and, thus, have arguably committed to greater minority investor protection. According to “bonding theory,” this should also have resulted in certain benefits, such as lowered cost of capital (John C. Coffee, Jr., “Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance,” working paper, Columbia University Law School, May 2002). This, then, would logically lessen the extent of further improvements that could otherwise be achieved from the adoption of IFRS. Prior research has indeed noted that U.S.-listed foreign entities have enjoyed lower cost of capital (Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, “Why Are Foreign Firms Listed in the U.S. Worth More?” *Journal of Financial Economics*, 71, 2004).

In summation, it is to be anticipated that research into the effects of IFRS adoption on the capital markets might be difficult and the results obtained might contain a fair amount of noise, making unambiguous conclusions difficult to achieve.

Nonetheless, based on a review of the literature, the author concludes that IFRS adoption will in many instances have a favorable impact.

Effects in the Real World

One study compared characteristics of accounting amounts for companies that adopted IFRS to a matched sample of companies that did not, and found that the former evidenced less earnings management, more timely loss recognition, and more value relevance of accounting amounts than did the latter. Reporting entities adopting IFRS had significantly higher variance of the change in net income (signifying less effort to smooth earnings), a higher ratio of the variances of the change in net income and change in cash flows, and a lower frequency of small positive net income (a sign that loss-making companies did not book questionable adjustments in order to create minimally positive earnings). IFRS adopters had a higher frequency of large negative net income and generally higher value relevance of accounting amounts. IFRS adopters also generally exhibited higher accounting quality in the post-adoption period than they did in the pre-adoption period. The results suggested an improvement in accounting quality associated with using IFRS (Mary E. Barth, Wayne R. Landsman, and Mark H. Lang, "International Accounting Standards and Accounting Quality," Research Paper No. 1976, Stanford University Graduate School of Business, September 2007).

Another study found that first-time mandatory adopters experience statistically significant increases in market liquidity and value after IFRS reporting becomes mandatory (Daske, et al. 2007). In the main analyses, the effects were found to range in magnitude from 3% to 6% for market liquidity and from 2% to 4% for Tobin's *q* (which compares the value of a company by market capitalization to the value of its assets by their replacement value), both assessed relative to the years prior to IFRS adoption. The results for changes in the cost of capital are mixed, possibly because markets anticipate the impact of the regulatory change or because the transition to IFRS disrupts the estimation of future cash flows for some time. Results for reporting entities voluntarily adopting

IFRS were similar, but possibly confounded by the signaling noted earlier.

Daske, et al. also found that the capital-market benefits were present only in countries with strict enforcement and in countries where the institutional environment provides strong incentives for transparent filings. In the other IFRS adoption countries, market liquidity and value remained largely unchanged in the year of the mandate. In addition, the effects of mandatory adoption were stronger in countries that had larger differences between national GAAP and IFRS, or without a preexisting convergence strategy toward IFRS reporting.

IFRS, being principles-based, does provide somewhat greater flexibility for reporting entities. (For example, either historical cost or revaluation models can be used in accounting for long-lived assets.) In a separate study, Daske, et al. considered differences between entities that, in those authors' terms, are "serious" versus those that only seek to use the IFRS "label," where seriousness is defined in terms of commitment to financial reporting transparency (Holger Daske, Luzi Hail, Christian Leuz, and Rodrigo S. Verdi, "Adopting a Label: Heterogeneity in the Economic Consequences of IFRS Adoptions," unpublished draft, April 2007). They found that serious adopters experienced significantly stronger (i.e., favorable) effects on the cost of capital and market liquidity than label adopters. An encouraging insight is that market participants are able, on average, to differentiate between the two categories of adopters.

Yet another encouraging finding is that the quality of financial statement disclosures was materially improved when IFRS was employed (Holger Daske and Gunther Gebhardt, "International Financial Reporting Standards and Experts' Perceptions of Disclosure Quality" *Abacus*, vol. 42, nos. 3/4, September 2006). The quality of disclosures, a key element of transparency, was evaluated by experienced financial statement users (accounting scholars) in various business journals in several countries, involving Austrian, German, and Swiss reporting entities' results. The results showed that disclosure quality, as perceived by the experts in their ratings of annual reports, increased significantly under IFRS, both statistically and economically, in the three countries. This result holds both in the cross section and

for entities switching from local to internationally recognized standards over time. Importantly, it does not hold only for companies that have voluntarily adopted IFRS or U.S. GAAP, but also for those that mandatorily adopted such standards in response to the requirements of the German stock exchange for specific market segments.

According to Daske and Gebhardt, "the findings ... provide large, sample-based evidence on the 'missing link' in the line of argument that 'higher quality' international accounting standards (IAS/IFRS; U.S. GAAP) lead to higher quality accounting reports that should ultimately lead to higher liquidity in the capital markets and lower cost of capital to the reporting entities."

Other research examined the adoption of IFRS by companies listed in the DAX 30 (the German blue-chip stock index). In 2004, 19 of the DAX 30 used IFRS as their basis of accounting for consolidated accounts, nine companies applied U.S. GAAP, and only two companies reported under German HGB (the national GAAP). This study examined the association between the book value of earnings and equity and market values of DAX 30 companies during the period from 1995 to 2004, specifically with respect to whether adopting IFRS or U.S. GAAP or cross-listing on the New York Stock Exchange (NYSE) improved or worsened the association between book values of earnings and stock prices. The results confirmed that adopting IFRS or U.S. GAAP or cross-listing on the NYSE significantly increased the value relevance of earnings relative to market prices (Eva K. Jermakowicz, Jenice Prather-Kinsey, and Inge Wulf, "The Value Relevance of Accounting Income Reported by DAX-30 German Companies," *Journal of International Financial Management & Accounting*, vol. 18, no. 3, September 2007).

Additional Factors

Adoption of IFRS is not the only factor, however. Having cited a few studies showing that IFRS adoption can result in higher perceived reporting quality and, hence, reduced perceived accounting risk—and thus, lower cost of capital—it must be conceded that others have found either a weak or no correlation, or have cited a range of other factors that might conceivably outweigh any beneficial effects of IFRS adoption. Ball notes that these other variables include:

- Extent and nature of government involvement in the economy;
- Government involvement in financial reporting practices (e.g., political influence of managers, corporations, labor unions, and banks);
- Legal systems (e.g., common law versus code law, shareholder litigation rules);
- Securities regulation and regulatory bodies;
- Depth of financial markets;
- Financial market structure (e.g., closeness of the relationship between banks and clients);
- The roles of the press, financial analysts, and ratings agencies;
- Size of the corporate sector;
- Structure of corporate governance (e.g., relative roles of labor, management, and capital);
- Extent of private versus public ownership of corporations;
- Extent of family-controlled businesses;
- Extent of corporate membership in related company groups (e.g., the Japanese keiretsu or the Korean chaebol);
- Extent of financial intermediation;
- The role of small shareholders versus institutions and corporate insiders;
- The use of financial statement information, including earnings, in management compensation; and
- The status, independence, training, and compensation of auditors (Ball 2006).

Ball, among many other observers, is concerned that the application of IFRS will not be uniform and that this will affect not only the quality of reporting by entities using non-standard IFRS (e.g., Euro-IFRS), but also the perception of quality by users. Furthermore, there will likely be a major challenge in educating auditors (as well as users) in the requirements under IFRS. Finally, the long-standing problem of auditors' willingness to make tough judgment calls (an issue exacerbated under the principles-based approach of IFRS) and to take tough stands against client demands (shown to be a daunting task, even when rules-based U.S. GAAP is being debated) remains.

A Challenging Future

There is certainly empirical research evidence to support the notion that uniform financial reporting standards will increase market liquidity, decrease transaction costs for investors, lower cost of capital, and facilitate international capital formation and

flows. Only one candidate is suited for the role of universal financial reporting standards—IFRS. In the author's view, there is sufficient basis to endorse IFRS and begin the challenging task of educating users, auditors, and regulators. Educators and practicing accountants alike have significant roles to play in this exciting—and seemingly inevitable—future. □

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