IMPLEMENTATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) AND THEIR IMPACT ON ECONOMIC GROWTH

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Abstract

The confidence in the transparency and integrity of financial reporting is critically important to global financial stability and sound economic growth.

The global financial crisis has led many economic and financial market participants to reexamine their governance, practices, and standards.

Effective financial reporting depends on high quality accounting standards as well as the consistent and faithful application and rigorous independent audit and enforcement of those standards.

Because of the global nature of the financial markets, it is very important to achieve a single set of high quality, globally converged financial reporting standards that provide consistent, transparent and relevant information, regardless of the geographical location of the reporting entity.

Key words: financial reporting, international accounting standards, implementation, economic growth
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Introduction

Accounting standards around the world have evolved over centuries of business and capital market development. In this process, accounting standards historically were designed to meet the needs of each nation's capital markets. Those standards that were found to work well in the legal, cultural, political and economic context of each nation became the "generally accepted accounting principles," or GAAP, for that particular jurisdiction. Naturally, different norms in each nation led to different GAAPs in each nation.

The growing dynamic of globalization presented a challenge to these "legacy systems." Global protocols for the internet, electronic payments, software systems and cargo shipping, demonstrated the potential value of uniform global systems. A discussion began among market participants over whether the global capital markets would similarly benefit by having a single set of high-quality accounting standards that could be applied around the world.

In order to create a uniform global system for financial reporting, the IASB (International Accounting Standard Board) was formed to serve as the global accounting standard-setting body. In 2001, the IASB promulgated the first iteration of IFRS, offering the possibility of a single set of high-quality accounting standards, that could be used by all nations.

The needs and effects of improved and more comparable financial reporting

Corporate reporting can have many economic consequences and it is impossible to enumerate all of them. Moreover, not all effects are well understood and supported by evidence. The one that is probably best supported by theory and evidence is the effect of reporting quality on market liquidity.[1]

The idea is that information asymmetries among investors introduce adverse selection into securities markets, i.e., less-informed investors are concerned about trading with better-informed investors. As a result, less-informed investors lower (increase) the price at which they are willing to buy or sell security, to protect against the losses from trading with better-informed counterparties.

Similarly, information asymmetry and adverse selection reduce the willingness of uninformed investors to trade. Both effects reduce the liquidity of securities markets, i.e., the ability of investors to quickly buy or sell shares at low cost and with little price impact. Effective corporate financial reporting can mitigate the adverse selection problem and increase market liquidity, by leveling the playing field among investors.

In addition, better reporting and disclosure can affect the cost of capital. First, there is the notion that investors require a higher return from less liquid securities, which is in essence a liquidity premium. Second, better disclosure can lower investors' estimation risks, i.e., make it easier for investors to estimate firms' future cash flows. This effect can directly reduce the required rate of return of an individual security as well as the market risk premium of the entire economy. Third, better disclosure can improve risk sharing in the economy, either by making investors aware of certain securities or by making them more willing to hold them, which again reduces the cost of capital. Empirical studies generally support a link between reporting or disclosure quality and firms' costs of capital.

It is also conceivable that better reporting improves corporate decision-making, for example the efficiency of firms' investment decisions. The idea is that higher quality reporting reduces information asymmetries that otherwise give rise to frictions in raising external capital. For instance, high-quality reporting facilitates monitoring by outside parties, such as institutional investors and analysts, which in turn can reduce inefficiencies in managerial decisions. The evidence on the effects of reporting quality on corporate decisions is still in its early stages, but there are a number of studies suggesting that better reporting leads to higher investment efficiency.

Finally, it is important to note that the effects of reporting and disclosure often extend beyond the firm providing the information. The disclosure of one firm can be useful to other firms for decision-making purposes but it can also help reduce agency problems in other firms. For instance, the disclosure of operating performance and governance arrangements provides useful

[1] **Hail, L.C.Leuz**.Global Accounting Convergence and the Potential Adoption of IFRS by the United States: An Analysis of Economic and Policy Factors, February 2009, p.9.

benchmarks that help outside investors to evaluate other firms' managerial efficiency or potential agency conflicts and, in doing so, lower the costs of monitoring. While the incremental contribution of each firm and its disclosures is likely to be small, these information transfers could carry substantial benefits for the market or the economy as a whole.

Another important dimension of corporate reporting is its comparability across firms. Making it easier and less costly for investors and other stakeholders to compare across firms can make corporate reporting more useful, even if the quality of reporting is held constant. For instance, more comparable reporting makes it easier to differentiate between less and more profitable firms or lowrisk and high-risk firms, which in turn reduces information asymmetries among investors and lowers estimation risk. These improvements resulting from greater comparability can also increase market liquidity and reduce firms' costs of capital (aside from the cost savings for investors). Similarly, more comparable reporting across firms from different countries facilitates cross-border investment and the integration of capital markets. Making it easier for foreigners to invest in a country's firms could again improve the liquidity of the capital markets and enlarge firms' investor bases, which in turn improves risk-sharing and lowers cost of capital.

In addition, better comparability can also have effects on corporate decisions and, in particular, gains from trade. More comparable reports allow firms to make better-informed investment choices due to a better understanding of competing firms, both within a country and across countries. Moreover, firms that have comparable financial reports can more efficiently contract with suppliers and customers in other countries. It may also enable them to bid more easily on government contracts in another country.

Comparability can also be viewed from a network perspective. Increasing the number of firms with directly comparable financial reports increases the number of two-way communication linkages in the "financial reporting" network, which enhances the value of the overall network to both investors and firms. As the network perspective emphasizes, one firm's adoption of more comparable reporting practices creates externalities on other firms. That is, other firms may benefit from an individual firm's reporting choices. However, firms themselves may not consider the aggregate positive externalities that arise from their own reporting choices.

Generally speaking, there is less empirical evidence on the effects of reporting comparability than reporting quality. Most archival studies that speak to comparability effects have been conducted in the context of firms' accounting standard choices.

It is important to note that, despite the tangible benefits of better and more comparable reporting and disclosure, there are also direct and indirect costs to improving corporate reporting. The direct reporting and disclosure costs come in many forms and include the preparation, certification and dissemination of accounting reports. These costs can be substantial, especially considering the opportunity costs of those involved in the process. Moreover, these costs are likely to have fixed components, making certain reports or disclosures particularly burdensome for smaller firms.

Disclosures can also have indirect costs because other parties can use information provided to capital market participants (competitors, labor unions, regulators, tax authorities). For example, detailed information about line-of-business profitability can reveal proprietary information to competitors.

In light of these costs and the cost-benefit tradeoffs that firms face, it may not be optimal to strive for the highest-quality reporting regime. In fact, forcing firms to provide certain disclosures can have net costs to firms, especially smaller firms. Thus, regulators and standard setters need to carefully weigh the confluence of costs and benefits to firms, investors, and other parties in the economy. Moreover, it is important to recognize that the net benefits of high quality and more comparable reporting vary significantly across firms, industries, markets and countries.

The importance of convergence to International Financial Reporting Standards

The international standard-setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations unable to establish their own accounting standards. But as the business world became more global, regulators, investors, large companies and auditing firms began to realize the importance of having common standards in all areas of the financial reporting chain.

The globalization of business and finance has led more than 12,000 companies in almost a hundred countries to adopt IFRS. In 2005, the European Union (EU) began requiring companies incorporated in its member states whose securities are listed on an EU-regulated stock exchange to prepare their consolidated financial statements in accordance with IFRS.

Australia, New Zealand and Israel have essentially adopted IFRS as their national standards. Canada, which previously planned convergence with U.S. Generally Accepted Accounting Principles (GAAP), now plans to require IFRS for publicly accountable entities in 2011. The Accounting Standards Board of Japan (ASBJ) and the International Accounting Standards Board (IASB) plan convergence by 2011.[2]

In a survey conducted recently by the International Federation of Accountants (IFAC), a large majority of accounting leaders from around the world agreed that a single set of international standards is important for economic growth. Of the 143 leaders from 91 countries who responded, 90 percent reported that a single set of international financial reporting standards was “very important” or “important” for economic growth in their countries.

Figure 1 demonstrates the perceived importance of IFRS regarding economic growth in nations throughout the world.

[2] International Financial Reporting Standards, an AICPA Backgrounder, New York, p.2.

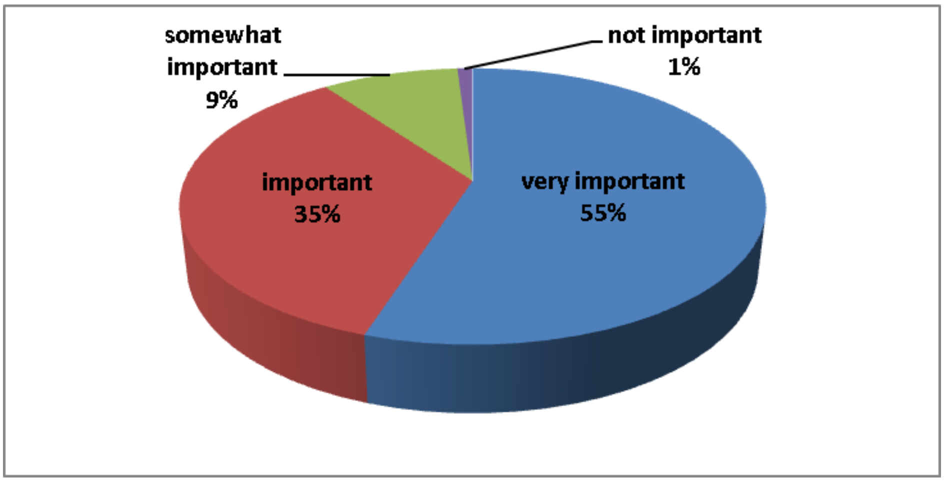

Fig. 1. Importance of convergence to IFRS for economic growth

As we can see from the data in illustration:

• 55 percent of respondents said IFRS adoption was "very important" to economic growth

• 35 percent said "important"

• 9 percent said "somewhat important"

• only 1 percent said "not important".

As the data shows, an overwhelming majority of international accounting leaders surveyed believe that adopting a unified set of accounting standards will be a significant factor in the continuing economic growth of their respective nations.

More than 100 countries have already adopted International Financial Reporting Standards, including a majority of the economically developed nations. Table 1 lists selected nations and their planned time to adopt IFRS.[3]

Table 1. Time of IFRS adoption for selected nations

Nation	**IFRS adoption**
Brazil	2011
Chile	2009
China	2011
European Union Nations	2005
India	2011
South Korea	2009

Several up-and-coming nations will adopt IFRS very soon and of allthe transitioning nations, those in the European Union (EU) may offer the most compelling examples of IFRS adoption.

[3]**Howard,J**. International Financial Reporting Standards. 2009, p.45.

Growing interest in the global acceptance of a single set of robust accounting standards comes from all participants in the capital markets. Many multinational companies and national regulators and users support it because they believe that the use of common standards in the preparation of public company financial statements will make it easier to compare the financial results of reporting entities from different countries.

They believe it will help investors understand opportunities better. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors.

Another benefit some believe is that in a truly global economy, financial professionals including CPAs (Certified public accountants) will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Similarities and differences between IFRS and national standards

To understand the challenges of adopting International Financial Reporting Standards in each country, it is important to understand both the similarities and differences between national standards and IFRS. From a broad perspective, both standards strive to provide relevant information to a "wide variety of viewers to make decisions". [4] These users could include investors seeking to evaluate the profitability of a company's stock or managers seeking to study the performance of their industry competitors.

Both IFRS and national accepted standards promote financial reporting that allows users with a reasonable degree of understanding, to compare data between reliable and easily understood format. Additionally, both sets of standards assume businesses are ongoing entities that strive to continue operations indefinitely and dictate account for transactions using the accrual method. This method states that various costs and revenues should be accounted for when they occur or are earned, not when cash actually exchanges hands. These conceptual similarities suggest that some national accepted standards (like GAAP in US) and IFRS are very similar in intention and purpose, but several key differences must be accounted for in the transitionary period.

IFRS are "principles based" guidelines that provide general guidelines on how to account for specific transactions. Because the guidelines are not laid out with definite steps for given transactions, accountants are required to exercise judgment in their work, creating increased risk for accountants as well as creating the possibility of inconsistency regarding different interpretations of similar events. These conceptual differences present a broad picture of key differences between the two sets of standards. However, the similarities and differences regarding specific elements of the standards will require careful consideration from companies in this transitionary period.

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[4] **Epstein,B.** The Economic Effects of IFRS Adoption, CPA Journal 79, no. 3, 2009,p.29.

Evidence from voluntary and mandatory IFRS Adoptions around the World and what accountants need to know

Empirical studies on the effects of IFRS reporting can be divided into two categories, depending on whether they analyze voluntary or mandatory adoptions.

Empirical studies on the economic consequences of *voluntary* IFRS adoptions generally analyze direct capital-market effects, such as liquidity or cost of capital, or the effects on various market participants, such as the impact on analyst forecast properties or on the holdings of institutional investors. In sum, the evidence on *voluntary* IFRS adoptions is somewhat mixed, but on balance suggests that voluntary adopters experience positive capital-market effects. However, these results have to be interpreted carefully. As firms choose whether and when to adopt IFRS, it is difficult to attribute any observed economic consequences to the accounting standards. It is possible, if not likely, that the effects are attributable at least in part to the factors that gave rise to the IFRS adoption decision in the first place. As a result, the evidence can inform us about the potential costs and benefits of IFRS for firms with particular characteristics but cannot provide a rationale for a mandate.

Studies on *mandatory* IFRS reporting either examine the stock market reactions to key events associated with the EU's movement towards mandatory IFRS reporting or analyze the effects around the introduction of mandatory IFRS financial statements in certain countries. In sum, there is some evidence of positive capital-market outcomes around the IFRS mandate in several countries. However, there is considerable heterogeneity in the effects across firms and countries. Moreover, as with the evidence from voluntary adoptions, it is not clear to what extent the documented effects can be attributed to IFRS, i.e., changes in the accounting standards.

The increasing acceptance of IFRS, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. Most accountants will somehow be affected. But this issue will have an impact far beyond just financial reports. It will affect almost every aspect of each country company's operations, everything from its information technology systems, to its tax reporting requirements, to the way it tracks stock-based compensation.

For the accounting profession, the use of IFRS by companies will create the need for effective training and education. Companies will use IFRS only if they and their auditors have been thoroughly trained, and if their investors and other users of their financial statements - such as analysts and rating agencies - understand IFRS as well.

Conclusion

The adoption of International Financial Reporting Standards worldwide will require the careful consideration of managers, accountants, and consumers who all rely of financial data to aid decision making. The acceptance of International Financial Reporting Standards (IFRS) as the preferred method of financial reporting on a global level leaves companies and accounting firms with many fundamental changes that will transform their traditional accounting models.

Using IFRS, companies and regulators feel that they will now have the ability to compare financial results across multiple country jurisdictions since they will all be using the same accounting standards. This will allow investors to understand and explore additional international opportunities.

Although it is widely viewed that implementation of IFRS will only impact the accounting department of companies, the effect is far reaching. Implementation of IFRS will encompass a company's entire operations including auditing and oversight, cash management, corporate taxes, technology and software.

In the short-term, companies should focus on continued understanding of the differences between IFRS and GAAP, monitoring adoption of IFRS by other countries for future business dealings.

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