**FINANCIAL REPORTING QUALITY AND INVESTMENT EFFICIENCY**

**Ass.professor Olivera Gjorgieva-Trajkovska,Faculty of Economics, University “Goce Delcev”, Stip, Republic of Macedonia**

**Ass.professor Aleksandar Kostadinovski, Faculty of Economics, University “Goce Delcev”, Stip, Republic of Macedonia**

***ABSTRACT***

*Accurate and transparent business and corporate reporting are in the spotlight today, more than ever before. National and also international market conditions and frequent company failures both highlights needs for transparency and efficiency in the process of generation and dispatching of information. Transparency is necessary in order to meet regulators and authorities requirements, while efficiency is important for enabling company executives to quickly respond to changing market conditions and meet investors and analysts needs.*

*The benefits of standardized and high quality financial reporting are: lower preparation costs, simplified and international access to information, standardized information recognized and understood by all recipients, high degree of required transparency by regulators, enhanced analytical capabilities and most important of all: enhancement of informed and efficient investment decisions.*

*KEY WORDS: information, transparent, standardized, investment, efficiency*

**Introduction**

Business is moving at an increasingly faster pace - a fact not lost upon the financial markets, which are loudly demanding business reporting to keep up. Companies face regular challenges in the dissemination of financial information both internally within their group and externally to the analysts, investors, local authorities and stock exchanges. It is clear that speed is of essence and loss of accuracy is an increasingly apparent risk.

One of the aims of financial reporting is to facilitate the capital allocation in economy which stems from investment decisions improvement. In fact, increasing of financial transparency is a potential factor for reducing the investment inefficiency. More financial reporting quality and using of valid convention and standards in reports and auditing preparation increase confidence in financial information users and decreases information risk, therefore, increases stock`s value. Importance of financial information quality multiples when some financial and nonfinancial events occur. Participants in these events need transparent information with high quality of firm’s performance and position to mitigate information asymmetry. However, the importance of present study is to discover the relationship between financial reporting and investment efficiency and also influential factors on this relationship in order to help users of financial statements in optimal decision-making.

Financial reporting quality can improve investment efficiency by reducing information asymmetry in two ways: (1) it reduces the information asymmetry between the firm and investors and thus lowers the firm’s cost of raising funds; and (2) it reduces information asymmetry between investors and the manager and thus lowers the shareholders’ cost of monitoring managers and improves project selection.

The two key constructs in the analysis are investment efficiency and financial reporting quality. We assume that a firm is investing efficiently if it undertakes all and only projects with positive net present value (NPV) under the scenario of no market frictions, such as adverse selection or agency costs. Thus inefficient investment includes passing up investment opportunities that would have positive NPV in the absence of adverse selection (underinvestment). Likewise, inefficient investment includes undertaking projects with negative NPV (overinvestment).Investment efficiency is measured as deviations from expected investment using a parsimonious investment model which predicts expected investment as a function of growth opportunities. Thus, both underinvestment (negative deviations from expected investment) and overinvestment (positive deviations from expected investment) are considered inefficient

investment.

We can define financial reporting quality as the precision with which financial reporting conveys information about the firm’s operations, in particular its expected cash flows, in order to inform equity investors. As described in the FASB Statement of Financial Accounting Concepts No. 1, financial reporting should “…provide information that is useful to present and potential investors in making rational investment decisions…” and “…provide information to help present and potential investors in assessing the amounts, timing, and uncertainty of prospective cash receipts...”. Further, expected cash flows is a key input to firm capital budgeting, which is particularly important in the context of this paper which studies financial reporting implications for corporate investment.

In general, there are three channels of firms’ financial reporting affecting firms’ investment efficiency. Accounting information (1) reduces capital market imperfections, (2) facilitates internal and external investment decisionmaking (project identification), and (3) enables external capital suppliers to monitor firms’decisions.

First, without financial market imperfections theoretically all investment opportunities with positive net present values are funded and implemented by firms. In reality, financial market imperfections are severe and firms’ resources allocation could be inefficient. For example, firms could suffer from financing constraints that limit their ability to fund potential projects suggesting that underinvestment may take place. Even if financing is available, managers’ allocation of resources could be inefficient due to overinvestment (e.g. empire building) resulting in a reduction of profitability and firm value. A general purpose of financial accounting information is to reduce adverse selection or moral hazard costs associated with information asymmetry to foster the efficiency of capital markets.

Second, financial accounting affects the economic performance of firms by providing information that helps managers to identify investment opportunities. As investment decisions depend on expectations about future growth and product demand, financial accounting information aids stating more precise expectations, and thus helps to distinguish resources from “bad” to “good” projects. Hence, higher quality financial reporting should improve firms’ investment decisions.

Third, financial accounting information acts as a control mechanism for external capital suppliers. Monitoring the firm through their financial disclosure, capital suppliers could evaluate their future cash flows, assess how risky their capital is invested, and if necessary intervene.

Neoclassical model of investment predicts that a firm will invest up to a level where the marginal cost of investing is equal to the marginal profitability of capital. Thus investment should only increase with underlying investment opportunities. However, the misalignment of managerial and shareholders incentives and asymmetric information between corporate insiders and the capital market could cause investment to vary with internal cash flows. Under the agency view, managers over-invest to reap private benefits such as “perks”, large empire, and entrenchment. Because external capital market disciplines managers from pursuing self-interested investment, an influx of cash flows enables managers to invest more. Under asymmetric information, managers in the interest of existing shareholders restrict themselves from external capital market due to costly external capital, and thus investment is expected to increase with internal cash flows. A substantial body of studies provide empirical evidence that corporate investment increases with internal cash flows. Furthermore, most of literature interprets a lower sensitivity of investment to cash flow as evidence of lower agency or information friction, thus lower investment distortions.

Traditional theories of corporate investments share the common assumption that capital market is efficient with respect to either disciplining misbehaved managers or incorporating all available information. However, a growing body of studies in accounting and behavioral finance suggests that the market efficiency premise should be viewed with some skepticism.

**The importance of high quality financial reporting**

Theoretical arguments and empirical evidence suggest a positive relation between reporting quality and growth. Specifically, findings show that a good financial reporting system lowers the cost of capital and improves capital allocation efficiency. These findings suggest that a high-quality financial reporting system is likely to facilitate economic growth, one of the ultimate goals of economic policy.

A better way to examine the implications of financial reporting quality for growth is by focusing on specific channels through which the effects of financial reporting may manifest. In particular, theoretical arguments suggest that high-quality financial reporting helps firms lower the cost of capital and improve project identification and project selection by reducing

information uncertainty and asymmetry. Absent information uncertainty and information asymmetry, managers can perfectly identify value maximizing projects and investors can contractually obligate managers to pick the value maximizing projects, making accounting information less useful. Therefore, we argue that the marginal benefit from financial reporting quality is higher in industries with more information asymmetry and uncertainty.

Overall, the results in many papers imply that financial reporting quality may not be a critical growth factor for countries that are heavily invested in low information uncertainty industries (e.g.,mature industries or industries with more tangible assets than intangible assets). However, as a country moves upward along the chain of industrial evolution and focuses more on industries with greater information uncertainty, such as high–growth or high–tech industries, a high-quality financial reporting system can play a pivotal role in fostering faster economic growth

The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making. Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency.

Although both the FASB and IASB stress the importance of high-quality financial reports, one of the key problems found in prior literature is how to operationalize and measure this quality. Because of its context-specificity, an empirical assessment of financial reporting quality inevitably includes preferences among a myriad of constituents. Since different user groups will have dissimilar preferences, perceived quality will deviate among constituents. In addition, the users within a user group may also perceive the usefulness of similar information differently given its context. As a result of this context and user-specificity, measuring quality directly seems problematic.Consequently, many researchers measure the quality of financial reporting indirectly by focusing on attributes that are believed to influence quality of financial reports, such as earnings management, financial restatements, and timeliness.

In 2002, the IASB and the FASB showed their commitment towards developing a common set of high-quality accounting standards, which could be used worldwide. As a consequence of the joint project to converge the more principles-based IFRS and the more rules-based US GAAP, both boards agreed to develop new joint Conceptual Framework, which includes the objectives of financial reporting and the underlying qualitative characteristics on which accounting standards ought to be based. In May 2008, the FASB and the IASB therefore published an exposure draft of ‘An improved Conceptual Framework for Financial Reporting’. This Conceptual Framework represents the foundations of the accounting standards. “The application of objectives and qualitative characteristics should lead to high-quality accounting standards, which in turn should lead to high-quality financial reporting information that is useful for decision making”. Furthermore, the conceptual framework ought to contribute to decision making of constituents, when transactions or events occur for which no accounting standards are available (yet). According to the ED, providing decision-useful information is the primary objective of financial reporting. Decision-useful information is defined as “information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers”.

**Global markets**

World markets are becoming increasingly intertwined. International consumers drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, watch U.S. movies, and use Arabian oil. The tremendous variety and volume of both exported and imported goods indicates the extensive involvement in international trade—for many companies, the world is their market.

To provide some indication of the extent of globalization of economic activity, Illustration 1-1 provides a listing of the top 20 global companies in terms of sales.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | Rank  ($ millions) | |  | | Company |  | | Country | |  | | Revenues | | ( | Rank  $ millions) | | |  | Company | | | |  | Country |  | | | Revenues |
| 1 | |  | | **Wal-Mart Stores** | | | U.S. | |  | | 378,799.0 | |  | | | 11 |  | | | **Daimler** |  | Germany | | | |  | 177,167.1 | |
| 2 | |  | | **ExxonMobil** | | | U.S. | |  | | 372,824.0 | |  | | | 12 |  | | | **General Electric** |  | U.S. | | | |  | 176,656.0 | |
| 3 | |  | | **Royal Dutch Shell** | | | Netherlands | |  | | 355,782.0 | |  | | | 13 |  | | | **Ford Motor** |  | U.S. | | | |  | 172,468.0 | |
| 4 | |  | | **BP** | | | U.K. | |  | | 291,438.0 | |  | | | 14 |  | | | **Fortis** |  | Belgium/Netherlands | | | |  | 164,877.0 | |
| 5 | |  | | **Toyota Motor** | | | Japan | |  | | 230,200.8 | |  | | | 15 |  | | | **AXA** |  | France | | | |  | 162,762.3 | |
| 6 | |  | | **Chevron** | | | U.S. | |  | | 210,783.0 | |  | | | 16 |  | | | **Sinopec** |  | China | | | |  | 159,259.6 | |
| 7 | |  | | **ING Group** | | | Netherlands | |  | | 201,516.0 | |  | | | 17 |  | | | **Citigroup** |  | U.S. | | | |  | 159,229.0 | |
| 8 | |  | | **Total** | | | France | |  | | 187,279.5 | |  | | | 18 |  | | | **Volkswagen** |  | Germany | | | |  | 149,054.1 | |
| 9 | |  | | **General Motors** | | | U.S. | |  | | 182,347.0 | |  | | | 19 |  | | | **Dexia Group** |  | Belgium | | | |  | 147,648.4 | |
| 10 | |  | | **ConocoPhillips** | | | U.S. | |  | | 178,558.0 | |  | | | 20 |  | | | **HSBC Holdings** |  | U.K. | | | |  | 146,500.0 | |

**Illustration 1-1. Listing of the top 20 global companies in terms of sales**

In addition, due to technological advances and less onerous regulatory requirements, investors are able to engage in financial transactions across national borders and to make investment, capital allocation, and financing decisions involving many foreign companies. Also, many investors, in attempts to diversify their portfolio risk, have invested more heavily in international markets. As a result, an increasing number of investors are holding securities of foreign companies. For example, over a recent sevenyear period, estimated investments in foreign equity securities by U.S. investors increased over 20-fold, from $200 billion to $4,200 billion. An indication of the significance of these international investment opportunities can be found when examining the number of foreign registrations on various securities exchanges.

As shown in Illustration 1-2, a significant number of foreign companies are found on national exchanges.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Exchange  (Location) | Total Share Trading  ($ billions) | Total  Listings | Domestic  Listings | Foreign  Listings | Foreign  % |
| NYSE (U.S.) | $30,214.8 | 2,447 | 2,030 | 417 | 17.04 |
| Nasdaq (U.S.) | 13,618.6 | 2,934 | 2,571 | 363 | 12.37 |
| Australian | 1,146.7 | 2,076 | 1,993 | 83 | 4.00 |
| Singapore | 237.8 | 770 | 460 | 310 | 40.26 |
| Tokyo (Japan) | 4,902.6 | 2,394 | 2,373 | 21 | 0.88 |
| London | 5,961.2 | 3,156 | 2,461 | 695 | 22.02 |
| Swiss | 1,379.8 | 324 | 253 | 71 | 21.91 |
| Deutsche Borse | 3,526.2 | 840 | 749 | 91 | 10.83 |
| (Germany) |  |  |  |  |  |

**Illustration 1-2. International Exchange statistics**

As indicated, capital markets are increasingly integrated and companies have greater flexibility in deciding where to raise capital. In the absence of market integration, there can be company-specific factors that make it cheaper to raise capital and list/trade securities in one location versus another. With the integration of capital markets, the automatic linkage between the location of the company and location of the capital market is loosening. As a result, companies have expanded choices of where to raise capital, either equity or debt. The move toward adoption of international financial reporting standards has and will continue to facilitate this movement.

**The Impact of IFRS on Firms’ Investment Efficiency**

Financial statements are the principal means through which a company communicates its financial information to those outside it. These statements provide a company’s history quantified in money terms. The **financial statements** most frequently provided are (1) the statement of financial position, (2) the income statement or statement of comprehensive income, (3) the statement of cash flows, and (4) the statement of changes in equity. Note disclosures are an integral part of each financial statement.

Some financial information is better provided, or can be provided only, by means of financial reportingother than formal financial statements. Examples include the president’s letter or supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management’s forecasts, and social or environmental impact statements. Companies may need to provide such information because of authoritative pronouncements, regulatory rule, or custom. Or they may supply it because management wishes to disclose it voluntarily.

Resources are limited. As a result, people try to conserve them and ensure that they are used effectively. Efficient use of resources often determines whether a business thrives. This fact places a substantial burden on the accounting profession. Accountants must measure performance accurately and fairly on a timely basis, so that the right managers and companies are able to attract investment capital. For example, relevant financial information that faithfully represents financial results allows investors and creditors to compare the income and assets employed by such companies as Nokia(FIN), McDonald’s (USA), Air China Ltd.(CHN), and Toyota Motor(JPN). Because these users can assess the relative return and risks associated with investment opportunities, they channel resources more effectively. Illustration 1-3 shows how this process of capital allocation works.

|  |
| --- |
| **Financial reporting** |
| The financial information a company provides to help users with capital allocation decisions |
|

|  |  |  |
| --- | --- | --- |
| **Users**  **(present and potential)** |  | **Capital Allocation** |
| Investors and creditors use financial reports to make their capital allocation decisions. | The process of determining how and at what cost money is allocated among competing interests. |
|  |

**Illustration 1-3. Capital allocation process**

An effective process of capital allocation is critical to a healthy economy. It promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities markets.

To facilitate efficient capital allocation, investors need relevant information and a faithful representation of that information to enable them to make comparisons across borders. For example, assume that you were interested in investing in the telecommunications industry. The five largest telecommunications companies in the world in descending order of revenue size are AT&T (USA), Verizon Communications (USA), Nippon Telegraph and Telephone (JPN), Deutsche Telekom (DEU), and Telefonica (ESP and PRT). How do you decide which, if any, of these telecommunications companies you should invest in? How do you compare, for example, a U.S. company like AT&T with a Japanese company like Nippon Telegraph and Telephone?

A single, widely accepted set of high-quality accounting standards is a necessity to ensure adequate comparability. Investors are able to make better investment decisions if they receive financial information from AT&T that is comparable with Nippon Telegraph and Telephone. Globalization demands a single set of high-quality international accounting standards. But how is this to be achieved? Here are some elements:

1. Single set of high-quality accounting standards established by a single standardsetting

body.

2. Consistency in application and interpretation.

3. Common disclosures.

4. Common high-quality auditing standards and practices.

5. Common approach to regulatory review and enforcement.

6. Education and training of market participants.

7. Common delivery systems (e.g., eXtensible Business Reporting Language—XBRL).

8. Common approach to corporate governance and legal frameworks around the world

Fortunately, significant changes in the financial reporting environment are taking place, which hopefully will lead to a single, widely accepted set of high-quality accounting standards is developed.

Recent empirical research in economics and finance investigates the relation between financial accounting information and economic performance. A general purpose of financial accounting information is to reduce costs of adverse selection or moral hazard associated with information asymmetries to foster the efficiency of capital markets. Hence, capital market frictions (e.g.,restrictions in raising external capital) should be mitigated by high quality information allowing external capital suppliers to better assess information about the firm’s investment opportunities and monitor managerial actions. Thus, higher-quality financial reporting should improve firms’ investment decisions. In line with this prediction, several empirical studies provide evidence that higher-quality financial reporting is associated with more efficient firm investment.

Here, we examine the impact of adopting IFRS on firms’ investment efficiency. IFRS is adopted by firms in more than 100 countries around the world seeking to harmonize firms’ financial accounting, and thus to facilitate comparability of firms in different countries. Besides the comparability effects, various other benefits are expected to come with an adoption of IFRS. Recently, there has been much research on the consequences of IFRS adoption. Several studies find that adopting IFRS leads to a higher accounting quality, more market liquidity and a lower cost of capital.

The only goal of IFRS is to provide decision useful information (e.g., IASB 2001), while the group accounts prepared under domestic GAAP often serve multiple goals. E.g., in several countries, for example Germany, the individual accounts which are influenced by taxation and dividend payout decisions are the basis for deriving the consolidated accounts. This might impair their decision-usefulness. In addition, IFRS provides more timely information and more disclosure in comparison to domestic GAAP. Hence, we expect a higher overall investment efficiency for firms applying IFRS. Managers’ overinvestment should decrease after the IFRS adoption because investors are better able to monitor managers. However, for public firms the effect on underinvestment could be muted because their access to external funds is rather developed. Focussing on the overall effect, we predict that IFRS adoption should lead to higher investment efficiency.

Financial economics theories argue that firms’ suboptimal capital investment processes are largely driven by the information asymmetry between firms and outside capital providers. Some finance theories demonstrate how the *ex ante* information asymmetry between managers and outside capital suppliers influences how a firm allocates its capital to investment opportunities. Other theories highlight how the *ex post* information asymmetry between shareholders and bondholders renders firms’ investment policy suboptimal.

If information asymmetries between managers and outside capital suppliers contribute to suboptimal investment policies, then a reduction in this asymmetry could ameliorate the problem. The adoption of better accounting policies and a subsequent increase in reporting quality could reduce this asymmetry; Biddle and Hilary (2006) find that reporting quality is negatively associated with the sensitivity of firms’ investment to cash flow. These results are upheld in a concurrent study using private company data by Chen *et al.* (2011), who find that private companies’ investment cash flow is negatively associated with accounting quality (proxied by discretionary accruals, discretionary revenues and total current accruals).

The adoption of a single set of global standards could reduce information asymmetry by improving the level of comparability of financial statements, therefore improving investors’ ability to identify good (and bad) investment opportunities. Comparability across companies and across countries could improve after the adoption of IFRS if investors, financial analysts, auditors, regulators and other stakeholders no longer need to understand financial statements that are prepared using different accounting standards from many jurisdictions, reducing information processing costs. Many researches find that the value relevance of goodwill, research and development expenditures, and property, plant and equipment revaluations is positively associated with the level of deviation between local accounting standards and IFRS, suggesting that the informativeness of these accounting items to investors increases after the mandatory adoption of IFRS.

In addition, the adoption of accounting standards that require a higher degree of disclosure can enable outside capital providers to more effectively compare value-creating investment projects with value-destroying investment projects.For instance, Li (2010) shows that the mandatory introduction of IFRS in the EU increases disclosure levels, resulting in lower cost of equity capital by an average of 47 basis points. If the disclosure level increases from compliance with the reporting requirements of IFRS, managers’ investment policies could become more visible to investors, increasing the transparency of firms’ investment policies and reducing information asymmetry.

As the level of disclosure and the comparability of financial information increases, agency problems stemming from information asymmetry with outside capital providers should decrease. Increased financial reporting quality, for example, facilitates the identification of positive NPV projects by outside capital providers, therefore it should be associated with reduced adverse selection problems (e.g., capital rationing by shareholders) that firms might encounter when issuing securities to finance positive NPV projects. Additionally, increased accounting transparency enhances external monitoring to reduce insiders’ dysfunctional behavior such as moral hazard, empire building, free cash flow problems and escalation of commitment, among others. Therefore, our first hypothesis stated in alternative form is:

IFRS requires a higher level of disclosure in financial reporting relative to most national accounting standards; an increased level of disclosure is linked to increased accounting quality and decreased information asymmetry between controlling shareholders and outside capital supplier. The improved financial reporting environment could increase the effectiveness of oversight and discipline that international financial intermediaries provide to markets, reducing the opportunity for controlling shareholders to expropriate returns from outside capital suppliers by undertaking value-destroying investment projects. Therefore, minority investors should be able to use the enhanced disclosures required under IFRS to identify dysfunctional investment processes of controlling shareholders.

On the other hand, a large body of the IFRS literature finds improved corporate governance consequences only for firms domiciled in countries with strong legal environments. For example, there are findings that the number of financial analysts following the firm increases after the adoption of IFRS only in countries with strong legal and political institutions, suggesting that the effects of the mandatory switch may be significant only in these countries. Wang and Welker (2010) examine the association between equity issuance and buy and hold returns with the unexpected change in prior year net income after the mandatory adoption of IFRS for firms in Australia and 14 EU countries. They find a stronger relationship between the change in reported accounting performance and market value for firms in countries with stronger legal institutions.

Under IFRS, companies are required to disclose more comprehensive information relative to local accounting standards; this higher degree of disclosure requirements is expected to reduce information asymmetry between controlling shareholders and outside capital suppliers. Reduced information asymmetry after the adoption of IFRS should allow current and potential outside capital suppliers to more easily identify controlling shareholders’ dysfunctional investment processes (e.g., under- and over-investment). Thus after the adoption of IFRS, outside capital suppliers monitor and discipline controlling shareholders’ self-serving investment policies. If the disclosure of more comprehensive financial information facilitates more effective monitoring mechanisms, controlling shareholders should not be able to expropriate wealth from outside capital suppliers as easily by undertaking value-destroying investment projects. A reduction in expropriation risk can decrease shareholder concentration by improving outside capital suppliers’ ability to identify firms that are attractive investment targets. If this is the case, firms with valuable growth opportunities that report their financial statements in compliance with IFRS should be able to attract sufficient external capital to finance profitable growth opportunities, increasing the efficiency of firms’ investment policies.

On the other hand, prior studies caution that unless firms’ reporting incentives provide a sufficient basis to encourage transparency, the adoption of IFRS could be in name only. Some note that reporting incentives and actual reporting behavior play a major role in the effects associated with the voluntary adoption of IFRS. While they find that the voluntary adoption of IFRS is associated with positive market effects (e.g., increased market liquidity, reduced cost of capital) on average, this effect is driven by firms that are serious about increasing financial transparency. They conclude that the greater effect is from a change in reporting incentives and actual reporting behavior rather than by the adoption of IFRS *per se*.

There are two mechanisms through which the adoption of IFRS could be associated with increased investment efficiency: increased financial disclosures and comparability. Our argument assumes that variability in enforcement across countries decreases with the mandatory introduction of IFRS, which is consistent with the increased focus on concomitant improvements in regulatory oversight, as illustrated in the EU. IFRS typically requires a higher level of disclosure and more comprehensive financial information than local accounting standards, resulting in increased disclosure of financial information and better accounting quality under IFRS compared to local GAAP when compliance is enforced.

A higher degree of financial disclosure should facilitate investors’ ability to extract financial information needed in the investment process. Consistent with this argument, one of the major reasons for the voluntary adoption of IFRS is to satisfy investors’ demand for a higher quality of financial information. The benefit from increased financial disclosures should be greater for firms in countries which have relatively more opaque local accounting standards compared to IFRS, while the mandatory adoption of IFRS is less likely to affect firms in countries that already enjoy high reporting quality.

The second mechanism through which compliance with IFRS could increase investment efficiency is by improving cross-border comparability between firms’ financial reporting. This positive informational externality from the enforcement of a single set of uniform accounting standards results when investors no longer have to translate firms’ financial reporting from local accounting standards to another using different accounting standards. And, the adoption of IFRS across multiple jurisdictions should reduce the costs of preparing and comprehending disparate sets of financial reporti, decreasing estimation risk and home-bias risk related to investments across borders. The evidence shows that the enhanced comparability resulting from the adoption of IFRS reduces the home-bias of U.S. mutual fund investors, increasing their cross-border investment in firms that are mandatory adopters in countries with more transparent informational environments. And research by Cascino and Gassen (2010) find that accounting comparability for some financial items has increased after the mandatory adoption of IFRS. They find that, except for goodwill, the variance in balance sheet line items reported after the adoption of IFRS decreases relative to the pre-adoption period and relative to their control group. These results are consistent with the mandatory adoption of IFRS having a positive impact on the comparability of balance sheet items. The benefits associated with increased comparability of accounting information after the mandatory introduction of IFRS could be more significant in countries whose domestic standard is more disparate to IFRS when enforcement is effective.

Important question, related with IFRS and investment efficiency is whether the mandatory adoption of IFRS is associated with a change in firms’ risk-taking behaviors. The analysis find that countries with weak investor protections are associated with sub-optimally conservative investment behaviors. They model firm investment and perquisite consumption decisions made by self-interested managers and find that managers avoid value-enhancing risk-taking to secure their consumption of perquisites. Their model suggests and their empirical analysis confirms that an increase in investor protections can mitigate these sub-optimal behaviors.

The conclusion is that the mandatory adoption of IFRS is associated with enhanced firm-level investment efficiency. After the mandatory adoption of IFRS, firms’ investment policy is associated with a shift towards a risk-adjusted optimal level while their investment-cash flow sensitivity decreases. Further, this association is more pronounced in countries with weak law enforcement institutions and higher ownership concentration. Considering these results collectively, we conclude that the adoption of IFRS benefits outside capital providers through the increased financial disclosure and comparability of accounting information, and thus, enhanced investment efficiency. This suggests that the use of IFRS is associated with enhanced investment efficiency at the firm-level, a matter of great importance to firm managers and regulators world-wide.

So, we can predict that following global IFRS adoption individual investors increase their investments in foreign stocks. This prediction is based on two assumptions. First, accounting information affects cross-border equity investments of individual investors, either because they use financial statements by themselves and/or because they consult information intermediaries (e.g., the business media or financial advisors) that in turn rely on financial statements. The second assumption is that country-specific accounting standards create entry barriers to investments in foreign stocks, because individual investors or the respective information intermediaries do not have the resources to familiarize themselves with local GAAPs. Global IFRS adoption removes these entry barriers by replacing country-specific accounting rules with one single set of standards.

**CONCLUSION**

Overall, this paper contributes to the extant accounting literature that investigates the economic implications of enhanced financial reporting, through implementation of IFRS. This literature has shown that financial reporting quality has economic consequences such as increased liquidity, lower costs of capital, and higher firm growth. This paper extends this research by showing that financial reporting information can reduce information asymmetries that impede efficient corporate investment policies.

We find that the mandatory adoption of IFRS is associated with enhanced firm-level investment efficiency. After the mandatory adoption of IFRS, firms’ investment policy is associated with a shift towards a risk-adjusted optimal level while their investment-cash flow sensitivity decreases. Further, we find that this association is more pronounced in countries with weak law enforcement institutions and higher ownership concentration. Considering these results collectively, we conclude that the adoption of IFRS benefits outside capital providers through the increased financial disclosure and comparability of accounting information, and thus, enhanced investment efficiency. This suggests that the use of IFRS is associated with enhanced investment efficiency at the firm-level, a matter of great importance to firm managers and regulators world-wide.

International convergence is underway. Many projects already are completed and differences eliminated. Others are on the drawing board. It appears to be only a matter of time until we have one set of global standards that will be established by the IASB. However, as one international regulator indicates, “the ultimate question remains whether IFRS will in fact function as the single set of high-quality, global accounting standards that the world has been seeking for so long. At least, when it comes to satisfying investors’ concerns, there is no question of the attractiveness of the promise of a truly global accounting standard. The only real question is not whether this is good for investors, but how quickly both the accounting standards and the process by which they are established and developed can be globally recognized as world-class.”

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**AUTHORS:**

**1. Ass.professor Olivera Gorgieva-Trajkovska,** Faculty of economics, University “Goce Delcev” Stip, Republic of Macedonia

**St.”Skopska” 72, 2300 Kocani, Republic of Macedonia**

**e-mail:** [**olivera.trajkovska@ugd.edu.mk**](mailto:olivera.trajkovska@ugd.edu.mk)

**2. Ass.professor Aleksandar Kostadinovski,** Faculty of economics, University “Goce Delcev” Stip, Republic of Macedonia

**e-mail: aleksandar.kostadinovski@ugd.edu.mk**