EFFECTS OF IFRS ADOPTION ON CAPTAL MARKET: EMPIRICAL EVIDENCE

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Abstract - This paper provides a review of the academic research relevant to the effect of the adoption of International Financial Reporting Standards (IFRS) on the capital market. It is intended to assist all interested parties in the debate on the future of IFRS in the EU and other countries that have adopted them, by looking at what can be learned from relevant academic research on the costs and benefits of its implementation to date, and their impact on capital market efficiency. The studies indicate mixed results as to the benefits of IFRS adoption which can be attributable to the political, economic, institutional, legal and firm specific differences among nations. The study is purely based on desktop research and library based research. The articles selected were reviewed and their findings presented in the study so as to help synthesize and understand the impact of IFRS on the capital market.

Keywords - IFRS, capital market, review, research, effects

I. INTRODUCTION

Accounting standards differ across countries. A common belief is that these differences reduce the quality and relevance of accounting information. The vision behind IFRS is that a single worldwide set of standards would permit investors anywhere around the world to benefit from a high level of comparability and a consistently high level of quality in financial reporting. It would eliminate the need for investors and analysts to try to understand financial statements that are prepared using different accounting standards from many jurisdictions, and it would eliminate one of the significant barriers to raising capital outside one's borders (Cox 2007).

The adoption of a single set of high quality accounting standards by companies throughout the world has gained significant support worldwide. The main argument behind this dissemination is that the use of one set of accounting standards would enhance comparability and transparency of financial information. Capital markets are one of the two main pillar of the financial system together with banking system (Pálosi-Németh B., 2007). The efficiency of capital market depends on a defined set of standards and principles, along with information accuracy and strong listing requirements.

Decisions makers in the capital market will have higher quality information especially if these accounting standards are applied in a rigorous and consistent manner (Daske et al., 2008). This would create more integrated capital markets which would lead to an efficient allocation of funds, a lower cost of capital and a flow of foreign investments. These have been the goals of the International Accounting Standards Board (IASB).These outcomes are very important to developing countries as their capital markets are suffering from thin trading, lack of liquidity and a lack of informational efficiency (Simpson, 2008).

Begining from January, 1, 2005, compliance with IFRS was made mandatory in the EU for the consolidated accounts of companies with securities traded on a regulated market, i.e. publicly traded companies, by Regulation 1606/2002. The Regulation's objectives were: improved transparency and comparability, better functioning of the internal market, the efficient and cost-effective functioning of the capital market, the protection of investors and maintenance of confidence in capital markets, and helping EU companies compete on an equal footing for capital within the EU and on world capital markets.

The Regulation was opposed by some people at the time, and the impact of IFRS in the EU has remained controversial since its implementation, especially since the financial crisis. Policy makers often say that they want to make policy based on evidence, and they may look to academic researchers to provide them with impartial and reliable evidence. The costs and benefits of mandatory IFRS adoption in the EU would appear to provide an ideal topic on which researchers might support the work of policy makers, and therefore in this report we summaries and discuss the findings of empirical academic research on this controversial subject. This is because standard setters, regulators and policy makers all have a vital interest in the effects of financial reporting on the economy. This interest is a result of economic consequences associated with objective, reliable and fair financial information. Financial information influences investor's behavior with respect to portfolio selection, which in turn affects security prices, and therefore, the terms on which a firm obtains additional financing.

Today almost every country around the world is moving toward IFRS in some way. Many countries have either adopted IFRS or based their local standards on IFRS.

II. IFRS ADOPTION EFFECTS

The International Accounting Standards Board (IASB) is a private organization of international scope established in 1973 and headquartered in London. It has issued a set of standards to be used when preparing financial statements, namely 41 International Accounting Standards (IAS) and 13 International Financial Reporting Standards (IFRS). IAS are standards issued by the IASB by 2001 and IFRS are standards issued after that year. Nevertheless, currently, the expression IFRS is commonly used alone to designate this set of rules (IAS and IFRS).

With growing prominence of IFRS, the demand for publications on the effects of adopting IFRS, country practical experiences in implementing IFRS, as well as future prospects of global accounting convergence is growing at exponential rates. There are a lot of studies that have examined the benefits of global accounting convergence and the capital market effects of IFRS adoptions.

2.1. Research on mandatory / voluntary adoption of IFRS

As pointed out by Ball (2006), since accounting is shaped by economic and political factors, harmonization of accounting standards and practices is almost an inevitable consequence of the increasing integration of markets and policies. This has been witnessed by the mandatory adoption of the International Financial Reporting Standards (IFRS) in several countries in the last decade. The adoption of IAS/IFRS required by European Regulation 1606/2002 for all listed companies in the European Union represented an extraordinary event for empirical research, as it became possible to investigate the effects of financial reporting under IAS/IFRS with specific regard to mandatory adoption at a European level. Early evidence documents that equity investors already perceived the benefits of IAS/IFRS adoption before the enforcement of Regulation 1606/2002. Comprix et al. (2003), for instance, identify 11 dates between 2000 and 2002 that signal the likelihood or the timing of the IAS/IFRS adoption in the European Union and find that the stock market reacted positively to news that increased the probability of IAS/IFRS adoption. Daske, Hail, Leuz and Verdi (2007a) examined the heterogeneity in economic consequences of voluntary IFRS adoptions around the world, recognizing that firms have considerable discretion in how they adopt IFRS. Some firms may simply adopt a label, while others view the decision as a serious commitment to transparency. They found that the economic consequences of IFRS adoptions depend on the extent to which firms make material changes to their reporting policies or have strong reporting incentives. In another paper Daske at al (2007b) analyzed the economic consequences of mandatory IFRS reporting around the world using a large sample that includes over 3,800 first-time adopters. They find that the capital-market benefits from implementing IFRS exist only in countries with strict enforcement regimes and institutional environments that provide strong reporting incentives. Also, the effects are weaker when local GAAP is more comparable to IFRS, in countries with an IFRS convergence strategy and in industries with higher voluntary adoption rates.

Sodestrom and Sun (2007) mainly focused on the analysis of studies addressing the impact of voluntary IFRS adoption in the EU. They emphasize the strong influence of the institutional context in the accounting information quality and warn about the impossibility to generalize outcomes regarding voluntary IFRS adoption for its mandatory adoption. Some studies have shown the major role played by enforcement regimes and firms' reporting incentives for capital market benefits from IAS/IFRS adoption. Daske et al. (2008), for instance, document modest but economically significant capital market benefits around IAS/IFRS mandatory adoption. However, such market benefits occurred only in countries where firms had incentives to be transparent and where legal enforcement was strong. In addition, the capital market effects of IAS/IFRS adoption were larger for firms in countries with domestic standards of lower quality and differing more from IAS/IFRS. Daske et al. (2013) also show the important role of reporting incentives around mandatory IAS/IFRS adoption in determining whether firms resist changing their reporting practices. Among value-relevance studies, Prather-Kinsey et al. (2008) provide evidence on the heterogeneity in the capital market consequences of mandatorily adopting IAS/IFRS by showing that firms from code law countries experienced more significant market benefits from implementing IFRS than firms from common law countries. A study by Beuselinck, C, Joos, P., Khurana, I. K., & Van der Meulen, S. (2009), analyzed data from 2,071 firms from 14 European Union Countries that mandatorily adopted IFRS. The study investigated the extent of an individual's stock returns movement in relation to the overall movements in the stock market prices (synchronicity) for firms that mandatorily adopt IFRS in the European Union excluding Luxemburg. They concluded that the adoption of the IFRS results to revelation of new information about a firm, therefore reducing surprise element of the disclosed information in the future. The study did not look at the incentives for IFRS adoption. The study is premised on a strong and transparent enforcement mechanism therefore, the findings of this study may not be applicable for countries with less enforcement mechanisms.

Armstrong et al. (2010) also investigate the European stock market reactions to 16 events associated with the adoption of IAS/IFRS in Europe, such as the European Parliament Resolution requiring all EU listed companies to use IAS/IFRS, or the endorsement of all IAS/IFRS except for IAS 32 and 39, or the IAS 39 endorsement with carved out provisions. They find that the stock market reaction was significantly positive (negative) in reaction to events that increased (decreased) the likelihood of the adoption and that the reaction was stronger for firms that did not cross-list in the United States. Aharony et al. (2010) focus on three accounting information items for which measurements under IAS/IFRS are likely to differ considerably from measurements under domestic GAAP: goodwill, research and development expenses (R&D), and asset revaluation. By using valuation models that include these three variables in addition to book value of equity and earnings, Aharony et al. show that adopting IAS/IFRS increases their value-relevance to investors. However, findings also provide additional evidence of cross-country differences in the incremental value-relevance of IAS/IFRS, with investors benefitting most from the implementation of IAS/IFRS for such items in the European Union countries where local standards deviated more from IAS/ IFRS.

A global study by Drake, M. S., Myers, L. A., & Yao, L. (2010) analyzed the effect of mandatory adoption of IFRS on market liquidity attributable to comparability effect, quality effect or both. The study used share turnover, market depth and bid-ask spreads as proxies for market liquidity. The study used data sampled from 5045 firms in 22 countries across the world from year 1993 to 2007. It was established that the mandatory adoption of IFRS results to increased market liquidity attributable to the enhanced comparability of accounting information. The study concentrated mainly on the mandatory adoption of IFRS. A review was undertaken to determine the progress of adopting IFRS in the European Union by Guggiola, G. (2010), the researcher observed that the ultimate goal of IFRS adoption and the harmonization of accounting is to deliver high quality information to financial markets and thereby helping to improve their efficiency which lowers the company’s cost of capital and increases companies access to capital. The study further observed that mandatory adoption of IFRS leads to improved knowledge on investors and the companies’ ability to utilize the IFRS, which improves the potential positive effects of IFRS adoption; this results to better accounting quality as the investors will demand for it.

A study to evaluate the impact of adopting IFRS on share prices and the trading volumes was conducted by Landsman, W. R., Maydew, E. L.,& Thornock, J. R. (2012). They collected data globally from 16 countries that mandatorily adopted IFRS and 11 countries that retained their domestic standards in the period from 2002 to 2007. They measured the information content of earning announcements based on abnormal trading volume and return volatility around firms’ earnings announcements. They observed that the content of information on earnings announcements improved after the adoption of IFRS, through reduction of reporting time lags, increase in investments by foreigners and increased accuracy of analysts predictions, therefore, improved quality of accounting. The study however, did not make the distinction between mandatory and voluntary adoption of the IFRS. Bruggemann, et al. (2012) discuss findings of empirical studies on the economic consequences of mandatory adoption of IFRS in the European Union (EU). They give specific consideration to those research studies investigating the effects of IFRS on the capital market, where they classify these research studies into two categories: studies directly analyzing economic consequences in capital markets using measures associated with firms values and studies indirectly measuring capital- market perceptions of accounting quality. They conclude that the financial reporting effects are limited because of substantial non compliance and accounting choices at the national levels that remain unchanged. They argue that there are unanimous evidence that the mandatory adoption of the IFRS coincides with capital market and macroeconomic benefits.

The study of Daske, H., Hail, L., Leuz, C., & Verdi, R. (2013) analysed firms adopting IFRS in a mandatory setting by collecting data from the year 1990 to 2005 obtained from 36 countries. They concluded that liquidity of capital markets increased with the adoption of the IFRS, they further found out that the cost of capital reduced with adoption of IFRS. The study’s limitation is that the data used was for the IAS, rather than the IFRS applicable at the moment. Dhaliwal, et al., (2013) provide initial evidence on the role of IFRS on financial market integration. They focus on the mandatory adoption of the IFRS and find a positive association between IFRS adoption and market integration measured based on two dimensions. The extent to which the global factors can explain local stock returns and the speed with which local stock returns incorporate global factors. They conclude that the relation between IFRS adoption and financial integration is obvious where there is a significant difference in quality between IFRS and local accounting standards and stronger legal enforcement. Brüggemann et al. (2013) also analyze studies on IFRS adoption in the EU, but they consider three categories of consequences: in financial reporting in the capital market, and those with a macroeconomic nature. These authors also introduce the distinction between intended and unintended economic consequences, depending on whether they are related to regulator's stated objectives. They stress that IFRS had a limited effect on financial reporting, due to a substantial non-compliance, persistence of national accounting standards of choice, and absence of improvement regarding transparency of outcomes and comparability measurements. On the other hand, they detected strong evidence that mandatory IFRS adoption brought macroeconomic benefits and benefits for the capital market.

The effects of adoption of IFRS on the integration of capital markets globally, focusing on the G8 Countries was examined by Alnodel, A. (2014). They sampled countries with IFRS as their required standards of financial reporting for their listed firms. The results of the study supported the belief that capital markets experience a higher level of integration post adoption of the IFRS adoption as compared to pre-adoption period. They further observed that the adoption of IFRS reduces accounting practices diversity which helps to facilitate efficient movement of capital. The study's main limitation is its failure to analyze the adoption as to whether it is mandatory or voluntary which is results to varying results.

The effect of IFRS on capital markets was examined by Procházka, D., & Pelák, J. (2015) in the post IFRS period in the EU by review of empirical evidence. They observed that the voluntary adoption of IFRS by firms leads to improved transparency through enhanced communication to the investors. This in turn gets appreciated through reductions in the cost of capital and increased following by foreign analysts. Further, they observed that the adoption of IFRS in the EU returned mixed results in Europe and therefore they found it not suitable to generalize that the adoption of IFRS will automatically lead to developments and improvements in capital markets. They attributed this to effects of country specific regulations. The conclusions about the EU may not be applicable to other contexts like developing countries. Despite the advantages usually associated with convergence to IFRS, the effect of adopting this set of standards is still a matter of debate (Hail, Leuz, & Wysocki, 2010a, 2010b; Christensen, 2012). There are reasons to believe that IFRS adoption, by itself, does not guarantee an increased information quality and comparability and a consequent improvement in the allocation of financial resources worldwide. Using the same rules is a necessary, but not sufficient condition to create a common language of financial information disclosure (Jeanjean & Stolowy, 2008). Manager incentives and institutional factors may also play a major role in determining the characteristics of financial statements. There are, today, some consensus around the idea that strict enforcement mechanisms and reporting incentives are indispensable to make the benefits of IFRS adoption come true (e.g. Kaya & Pillhofer, 2013; Barth, Landsman, Lang, & Williams, 2012; Brown, 2013; Leuz, 2010; Ball, 2006). Another aspect not often mentioned, but stressed by Brown (2011), is related to the importance of training staff directly involved in the production of financial information.

DISCUSSION OF THE REVIEW FINDINGS

Most studies show empirical evidence of an effect of IFRS adoption that is positive or mixed. Some of the studies showing there is a positive effect also provide evidence on a number of factors affecting this effect, particularly companies' characteristics, countries' characteristics, the way how IFRS are adopted (voluntary or mandatory), or the differences between the local standards and IFRS. The adoption of the IFRS has had numerous impacts on the quality of accounting information and the general development, growth and performance of capital markets worldwide. Most of the research was done in the developed economies while from the reviewed literature fewer studies were from developing countries. Developed countries are characterized with strong legal enforcement mechanisms which guarantee full adoption benefits of the accounting standards, which ensures the benefits of adoption. Developing countries have weak legal enforcement mechanisms and corruption which constraint full implementation of the IFRS, therefore, resulting in unrealized benefits of IFRS adoption. Further, the study observes that adoption of IFRS results to the following capital market effects:

1. Stock market react positively to news that increase probability of IFRS adoption;
2. The adoption of the IFRS results to revelation of new information about a firm, therefore reducing surprise element of the disclosed information in the future.
3. The content of information on earnings announcements improved after the adoption of IFRS, through reduction of reporting time lags, increase in investments by foreigners and increased accuracy of analysts' predictions, therefore, improving quality of accounting.
4. Liquidity of capital markets increased with the adoption of the IFRS, and also the cost of capital reduced with adoption of IFRS.
5. Mandatory adoption of IFRS leads to improved knowledge on investors and the companies' ability to utilize the IFRS, which improves the potential positive effects of IFRS adoption.
6. The relation between IFRS adoption and financial integration is obvious where there is a significant difference in quality between IFRS

and local accounting standards and stronger legal enforcement.
7. IFRS adoption brought macroeconomic benefits and benefits for the capital market.
8. The voluntary adoption of IFRS by firms leads to improved transparency through enhanced communication to the investors. This in turn gets appreciated through reductions in the cost of capital and increased following by foreign analysts.
9. The adoption of IFRS reduces accounting practices diversity which helps to facilitate efficient movement of capital.

Besides these benefits of the process of IFRS adoption, there are also some studies with mixed results and heterogeneity in the capital market consequences, depending on country specifics, as:

1. Firms from code law countries experienced more significant benefits from implementing IFRS than firms from common law countries.
2. Adopting IAS/IFRS increases their value-relevance to investors in countries where local standards deviated more from IAS/IFRS.
3. IFRS had a limited effect on financial reporting, due to a substantial non-compliance, persistence of national accounting standards of choice, and absence of improvement regarding transparency of outcomes and comparability measurements.
4. The economic consequences of IFRS adoptions depend on the extent to which firms make material changes to their reporting policies or have strong reporting incentives.
5. The capital-market benefits from implementing IFRS exist only in countries with strict enforcement regimes and institutional environments that provide strong reporting incentives.
6. There is strong influence of the institutional context in the accounting information quality and that's why it's impossible to generalize outcomes regarding voluntary IFRS adoption for its mandatory adoption.
7. One limitation is related to the importance of training staff directly involved in the production of financial information.

Some studies also provide evidence of a null effect of IFRS adoption on information quality and the capital market which may be explained by a greater similarity between local standards and IFRS, when compared to local standards used in many countries.

CONCLUSIONS

In most countries, IFRS adoption is associated with a significant paradigm shift. The application of a set of rules gives room to the application of a set of principles aimed at providing useful information to make economic decisions. IFRS adoption is associated with an increased complexity in the accounting system, which now requires a higher degree of assessment and greater commitment of managers at various levels within the company and it is also characterized by a move away from accounting towards taxation and a significant increase in the amount of disclosure. Nevertheless, it is expected that the benefits resulting from IFRS adoption are higher than the costs associated with this paradigm shift.

In summary, most studies examine the effect of IFRS adoption on information quality and the capital markets, with a predominance of samples that include a large number of countries. The results indicate that, as a general rule, IFRS adoption has a positive effect, but it particularly depends on countries' characteristics (notably enforcement level) and companies' characteristics. Factors different from accounting regulation play a key role in determining financial reporting quality and have actually led to an application of IAS/IFRS, which is not uniform across Europe, with consequences on accounting quality both in absolute and relative terms. Empirical findings suggest that cross-country differences in accounting are also likely to remain after IAS/IFRS adoption. So, sharing rules is not, by itself, enough to create a common business language.

According to this view, this paper concludes by providing some guidance for future research and the policymaking debate.

First, while empirical evidence on the role of institutional settings and firms' incentives in shaping accounting quality is quite compelling, some caution must be shown in drawing definite conclusions on the effects of mandatory IAS/IFRS adoption on financial reporting quality.
Second, there is a need for carefully studying whether the effects that are attributed to IFRS adoption will not be the result of other economic factors at stake in a dynamic global economy.

Another important question is related to whether the consequences of IFRS adoption are different depending on the kind of standards adoption (just as issued by the IASB, as it occurred, for instance, in the EU, different from the consequences of a convergence of national standards with IFRS, as it happened, for instance, in Australia). Also, studies addressing the consequences at the level of small companies are crucial to properly inform decision-makers in terms of accounting standards, as most of the studies include samples of large companies.
Another question which deserves further attention and debate is the use of fair value accounting which is supposed to ensure a higher degree of transparency in financial statements, but there are some doubts regarding its usefulness to investors.

Another topic which deserves further scrutiny is the relative informativeness of IAS/IFRS versus US GAAP. This implies an increasing convergence of accounting standards currently used internationally with the ultimate objective of achieving a single set of global accounting standards. Also the lack of a global regulator to ensure uniform adoption and enforcement reduces the benefits of common accounting standards. Therefore, there is a need to develop mechanisms that contribute to really making capital markets more integrated and to maximize the efficiency of international accounting standards.

At the end, but not less important, researchers in developing countries should consider the applicability of the empirical findings in other countries to their economies, since the applicability of the IFRS adoption variables changes from country to country.

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