THE FUTURE OF IFRS (IINTERNATIONAL FINANCIAL REPORTING STANDRADS)

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Abstract

A universal 'financial language' offers many well-documented advantages. Cross-border businesses benefit from reduced preparation costs, and cross-border trading in securities increases as international investors can more readily compare the performance of companies based in different countries. In turn, it is argued that this results in increased market efficiency and a reduction in the cost of raising capital for companies, which ultimately helps to boost growth.

The rapid spread of IFRS around the globe in the past decade means that those benefits are no longer theoretical as a growing body of research shows they are increasingly evident in practice. Today well over 100 countries – including more than two-thirds of the G20 – require or allow their listed companies to prepare annual financial statements based on IFRS. But momentum has slowed as major projects have stalled and the US and other significant economies have become hesitant as they consider whether or not to commit to IFRS. Against this backdrop, a range of important questions are now being asked about where the IFRS project goes from here.

Turning the vision of a truly global set of standards into a reality involves huge challenges that are likely to require significant organisational change at the IASB , alongside constructive commitment by all key stakeholders around the world.

U.S. investors expect the country will eventually support International Financial Reporting Standards, but the process will take time and require substantial investment in staff and training, according to new research from the Association of Chartered Certified Accountants.

More investors believe the eventual adoption of IFRS in the USA will result in a net benefit to the American economy than not. In ACCA's view, U.S. adoption of IFRS would give a tremendous boost to the cause of globally comparable financial reporting, and more importantly, the US and world economies. ACCA has repeatedly called for putting investors at the heart of the standard-setting process globally.

Key words: IFRS, future, adoption, convergence, setting process

Introduction

In the midst of the global financial crisis that began in mid-2007 with the bursting of the bubble in the United States housing market, the G20 group of countries publicly endorsed the aim of establishing a single set of high-quality global accounting standards. Much has been achieved since then, with use of International Financial Reporting Standards (IFRS) – the standards published by the International Accounting Standards Board (IASB) – continuing to spread across the globe. There is a growing body of evidence that as the use of IFRS has grown, financial information has become more transparent and more comparable.

So while some continue to argue that the momentum behind IFRS becoming a truly global set of accounting standards is irreversible, others claim that there is a danger that the coalition of countries supporting IFRS could break apart, and that, rather than moving inexorably towards a single set of accounting standards, we could return to a world of highly fragmented national standards and national standard-setting.

It is important, however, to step back and put things into perspective. We should remind ourselves that the idea of a set of global standards isn't a new one. Put simply, supporters of a single language of accounting should not be unduly dismayed by recent setbacks – such an ambitious international project will inevitably encounter delays and disappointments along the way.

Effects of improved 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.

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 (sell) a 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. Corporate disclosure can mitigate the adverse selection problem and increase market liquidity by leveling the playing field among investors. Empirical studies support this argument and provide evidence that better disclosures reduce information asymmetry and increase market liquidity.

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

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 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. Empirically, the aggregate effects of such information transfers and governance spillovers are still largely unexplored, but this does not imply that they are less real or irrelevant.

Of course, switching to a new accounting framework also presents businesses with considerable costs and short-term challenges. Accounting policies need to be assessed and updated. Information systems need to be upgraded or replaced. Controls need to be redesigned. Employees need to be trained, and investors need to be educated.

So transition can be painful. But it is often accompanied by wider, incidental benefits. By encouraging companies to reconsider, for example, relevant processes, controls, IT systems, business practices and accounting policies, new ideas and better ways of doing things often emerge. Short-term pain can result in longer-term practical gains, for regulators and others as well as businesses, over and above the oft-quoted benefits of lower accounting costs, increased comparability and a lower cost of capital.

Where is the world today – from the aspect of IFRS development?

The spread of IFRS around the globe has been – and continues to be – a remarkable success story. When in 2002 the EU made its landmark decision to require all of its listed companies to use IFRS in their consolidated financial statements from 2005 onwards, few would have anticipated that so many of the world's major economies would follow suit quite so quickly.

Today well over 100 countries, including more than twothirds of the G20 countries, require or allow their listed companies to prepare their financial statements using IFRS or national standards based closely on IFRS.

This does not mean that in each of those jurisdictions all companies are required to apply IFRS, or that IFRS are adopted without amendment. For example, while most publicly accountable entities in Canada must prepare their financial statements using IFRS, some – most notably those that have rate-regulated activities – do not currently have to apply IFRS. While all listed entities in some major jurisdictions except financial institutions must prepare their financial statements using IFRS, in others it is only such institutions that must use IFRS.

However, despite such limitations, the spread of IFRS does mean that the financial information published by major international businesses – which is where the case for global standards is strongest – is more comparable than ever before.

Throughout the past decade, the IASB has been working closely with the US standard-setter, the Financial Accounting Standards Board (FASB), to converge the requirements of IFRS and US GAAP. Today the two sets of standards are significantly more aligned than they were a decade ago. The success of the convergence project is perhaps best illustrated by SEC's acceptance that IFRS are a highquality accounting framework. Some would point to the forthcoming converged standard on the critical topic of revenue recognition as a key success. But the formal era of convergence is expected to draw to a close once the outstanding joint projects have been completed.

This indecision – along with other salient factors such as the global financial crisis, the inability of the IASB and the FASB to reach full agreement on some of their remaining convergence projects, and various local concerns – has had an effect on other countries, which have also delayed decisions on IFRS adoption. So, while in the last few years a number of major economies – including Brazil, Canada, South Korea and Mexico – have successfully made the move to IFRS, some momentum has been lost. Japan has announced that its plans to move to IFRS have been delayed, with mandatory adoption in 2015 or 2016 no longer a possibility as had once been hoped. Plans for Indian companies to transition to a new domestic GAAP based on IFRS have not yet come to fruition. In both cases, no new date for switching to IFRS has yet been set.

So, after a period when it seemed that IFRS might sweep the world in short order, progress has slowed, and there are growing concerns over whether a single set of international accounting standards is an achievable goal. Many are concerned that some significant economies – the United States, Japan, India and others – have yet to commit to adopting IFRS, or to incorporating them without substantial modification into their domestic standards.

How, some ask, can IFRS be regarded as a truly global set of standards when such major players are continuing to drag their feet over if, when and how they will finally join the IFRS community?[1] If the United States in particular continues on its own path, what are the implications for the success of IFRS?

Others, including the staff of the SEC, are worried about just how consistently the standards are being applied by those countries which have already adopted IFRS – the extent to which they are speaking one global 'language' rather than a series of local 'dialects'. If the IASB cannot prevent local standard-setters adapting IFRSs to fit their local needs rather than adopting them wholesale, or deter them from issuing local interpretations, is there a viable future for global standards?

In the wake of the global financial crisis, some have also begun to ask more serious questions about IFRS. Were they somehow responsible for the crisis or at least for exacerbating the downturn, and if so, would IFRS countries be better off returning to their previous domestic GAAPs?

Finally, the success of the IFRS project in itself spawns a further challenge. As more and more countries adopt the standards, it will undoubtedly become harder to reach a global consensus on significant changes.

The perspectives of IFRS adoption and development

From the point of view ICAEW - a professional membership organisation, supporting over 138,000 chartered accountants around the world, the end of the formal era of convergence between IFRS and US GAAP is said to be near. After more than 10 years of working in close tandem, the IASB and the FASB are due to bring their formal partnership to a close. Just what role the United States will play in the future development of IFRS remains unclear, but the nature of its role is very important for the future direction of international accounting.

Nonetheless, the United States remains the world's largest capital market. It is unique in its size and influence. Its long tradition of standard-setting sets it apart from many other countries that have adopted or are considering adopting IFRS. It has much to contribute by way of financial reporting expertise.

Continuing to work with US standard-setters will only serve to make IFRS stronger in the longer term, further increasing the prospects of their global acceptance, especially if knowledge of US GAAP gradually declines around the world. Thus the IASB must continue to liaise closely with the US regardless of whether the US commits to adopting IFRS or incorporating IFRS into US GAAP in the short to medium term.

However, the IASB must not put reaching agreement with the United States ahead of finding quality solutions. Dialogue is always a good thing, and

[1] "The future of IFRS – Information for better markets initiative", Financial reporting faculty, icaew.com

the outcome of some of the convergence projects – perhaps most notably the revenue recognition project – shows what the boards can achieve when they work well together. But other projects have not gone so well. For example, the short term prospects for agreement between the two boards on financial asset impairment, lease accounting and insurance look – to varying degrees – bleak.

Conclusion

Turning the vision of a truly global set of standards into a reality involves huge challenges that are likely to require significant organisational change at the IASB , alongside constructive commitment by all key stakeholders around the world.There are some fundamental issues to address in the future. Some of them are listed bellow.

Evidence-gathering will be critical in future, but the challenges involved in ensuring that the right research is undertaken by the right bodies, at the right time, with the right degree of IASB oversight, should not be underestimated.

The complexity of IFRS reporting requirements may discourage some countries from fully embracing international standards; the IASB should strive to minimise unnecessary complexity in its standards and hold fast to the vision of principles-based standards that require a reasonable degree of judgement.

There is a need to establish operable models for undertaking effects studies and post-implementation reviews. There are few good precedents. The IASB should be prepared to redesign the approach and scope of reviews should initial results prove disappointing.

Major changes in the scope and reach of the board's activities will not be possible unless the IFRS Foundation's funding system is established on a secure and sustainable basis.

Success is not guaranteed. But there is a real hope that these challenges can be overcome with the full and constructive support of IFRS stakeholders.

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