Global Accounting Convergence and the Potential Adoption of IFRS by the U.S.

Christian Leuz
Keynote Presentation at the LSE MBS Conference

Motivation

• SEC proposed Roadmap to IFRS, which could lead to IFRS adoption by the U.S. in 2014
• FASB asked for an independent research report on economic and policy factors related to this decision
  – Report was attached to FASB’s comment letter to SEC
• Game plan for keynote:
  – Key insights from research report
  – Example for how academic research can inform policy decisions and policy makers
  – Research challenges (and opportunities) in this area
Roadmap for our Research Report

• Joint work with Luzi Hail (Wharton) and Peter Wysocki (MIT)
• Our report provides an analysis of economic and policy factors related to IFRS adoption in the U.S.
  – Cost & benefits of high-quality and of comparable reporting (Section 2)
  – Role of standards for high-quality reporting (Section 3)
    ▪ Importance of reporting incentives
    ▪ Evidence on the effects of IFRS adoption in other countries
  – Costs and benefits of IFRS adoption in the U.S. (Section 4)
    ▪ Firm-level and economy-wide effects
  – Standard setting process and political considerations (Section 5)
  – Possible future scenarios for U.S. accounting standards (Section 6)
    ▪ There are many ways to IFRS adoption

High-Quality and Comparable Reporting

• High-quality reporting and corporate disclosure can
  – Increase market liquidity and reduce cost of capital
  – Improve the capital allocation and portfolio decisions
  – Facilitate monitoring and improve corporate decisions
• More comparable reporting makes it easier and less costly to compare investment opportunities
  – These effects can reduce information asymmetries among investors
  – Greater comparability could discipline firms’ reporting behavior and improve reporting quality
  – Again, effects on market liquidity and cost of capital
• But the key question is: How do we get there?
• Net benefits vary across firms, industries, markets, and countries
What is the role of accounting standards?

• Important question
• Role of standards for reporting quality and comparability is more limited than often thought
• Academic studies show that firms’ reporting incentives are at least as important for actual practices
  – Standards offer a substantial amount of discretion
  – How the standards are applied and how discretion is used depends on managers’ reporting incentives
  – Incentives are shaped by many factors, e.g., investor protection, litigation, capital markets, enforcement
• Major contribution by the international accounting literature

Role of Accounting Standards

• Supporting infrastructure and reporting incentives play an important role for reporting practices
• Important implications:
  – A single set of accounting standards by itself does not guarantee the comparability of firms’ reporting practices
  – Applies within a country and across countries
  – This is not just a matter of enforcement
• If true reporting comparability is the goal, we need to focus on countries’ institutional infrastructures
Opportunities

• Exploit IFRS adoptions around the world
• Rare opportunity to analyze the imposition of an entire set of accounting rules
  – We have many studies on individual standards
• Opportunity to study comparability effects and externalities from accounting regulation
  – We have few studies on such effects and little evidence at the economy level (Leuz & Wysocki, 2008)
  – Other work focuses on broad changes in securities regulation

Challenges

• Primary challenge: Identification of IFRS effects
  – Does corporate reporting improve or become more comparable with the introduction of IFRS?
  – Are the documented effects attributable to IFRS?
• If we want to inform policymakers (on the mechanism), it is important that we (ultimately) can draw causal inferences
• Important questions:
  – What determines how well financial statements convey information to market participants?
  – What is the contribution of accounting standards?
  – Separating measurement and disclosure effects

5/20/2009
Evidence on IFRS Adoption Around the World (Daske, Hail, Leuz and Verdi, 2008)

- Capital-market effects of IFRS mandate in 26 countries
- We find that a (modest) increase in market liquidity and valuations
- Evidence for cost of capital is mixed
- Substantial heterogeneity in the capital-market effects
  - No effects in countries with weak enforcement and weak reporting incentives
- Challenges:
  - Many countries have chosen to require IFRS reporting as of December 2005
  - Difficult to isolate effects of IFRS mandate from other factors (e.g., general time trends, one-time shocks)
  - Short-lived adoption effects and anticipation effects
  - Concurrent changes in institutional infrastructure to support IFRS adoption (e.g., changes in enforcement, governance, etc.)

Benchmarking
Evidence on IFRS Adoption around the World (Daske, Hail, Leuz and Verdi, 2008)

- Voluntary adopters experience strong effects in the year when mandatory IFRS reporting is introduced
  - Effects are stronger than for mandatory adopters
  - Effects are unlikely due to IFRS (i.e., the standards) as these firms have already adopted IFRS in earlier years

- Possible explanations
  - Comparability effects (i.e., externalities from mandatory adoption)
  - Concurrent changes in countries’ institutional frameworks (e.g., governance, enforcement, etc.)
  - Improvements and learning effects (e.g., dual reporting)

- We have to be careful to attribute findings to IFRS per se

Adoption Rates for Identification

- Relate changes in aggregate liquidity and changes in aggregate adoption rate (by country and month)
  - Captures externalities and effects on other firms

- Technique that could be used in other settings

- Effects in DHLV (2008) are smaller in magnitude when using this identification strategy
  - As this technique is better at isolating reporting effects, some of the effects are probably not solely attributable to IFRS

- But it does not fully separate effects of the standards and associated enforcement changes
IFRS Adoption in the U.S.

• U.S. economy and institutional framework are unique in many respects

• Even if switching to IFRS has been beneficial for some countries, not obvious that the same would be true for U.S.

• Specifics of the U.S. economy and institutional framework
  – Largest economy and largest capital market (but also quite diverse)
  – Heavy reliance on external financing
  – Large fraction of U.S. households hold debt and equity securities
  – Large demand for transparent reporting and investor protection
  – Strong enforcement (public and private mechanisms)

• Another area where research has made major contributions
IFRS Adoption in the U.S.
Reporting Quality is not the Issue

• IFRS adoption is unlikely to have large effects on the quality of U.S. financial reporting
  – We do not expect a major increase or a major decline
• U.S. already has a set of high-quality accounting standards
• Focus on standards in the debate is misleading
• U.S. institutional infrastructure and market forces provide strong incentives for transparent reporting
• As supporting infrastructure remains in place, reporting quality is unlikely to deteriorate
  – Even if IFRS provide more discretion and less guidance

IFRS Adoption in the U.S.
Comparability Effects

• IFRS adoption in the U.S. likely generates comparability benefits
  – Stem from adoption of a single set of standards, which restricts the set of permissible accounting treatments
• But benefits for the U.S. are likely to be muted
  – Comparability (or network) effects are likely to be larger for smaller countries with few firms – U.S. network is large
  – Firms and countries have incentives to implement IFRS in a way that fit their particular infrastructure and needs – Reporting incentives
  – U.S. GAAP and IFRS are already fairly close
• It is likely that a large fraction of the comparability effects took place when other countries switched to IFRS
• We have a lot less research on the effects of comparability
IFRS in the U.S.:
Main Effects are on the Cost Side

- Cost savings to firms by moving to a single set of standards
  - In most countries, statutory and tax reporting are not based on IFRS
  - Many firms still have (at least) two sets of standards or need to perform a reconciliation

- Switch to IFRS is costly to firms, investors and the U.S. economy
  - Transition costs to firms and investors
  - Costs for the adjustment of the institutional infrastructure

- Costs and benefits of IFRS adoption are heterogeneous across firms and industries
  - Smaller firms are likely to face relatively bigger costs
  - Degree to which firms have global operations is an important factor

Compatibility with U.S. Infrastructure and Macroeconomic Effects

- Notion of institutional fit
  - Changing one element can lead to undesirable outcomes

- IFRS allows more discretion in reporting and provides less guidance
  - More a function of age than a fundamental difference
  - U.S. GAAP also started out as “principles-based” and evolved over time

- IFRS will face same pressures in U.S. (e.g., litigation system)
  - These pressures will likely hinder international comparability over time

- IFRS adoption is unlikely to have major macroeconomic effects in the U.S.
  - Re-distributional effects across firms and service providers
IFRS in the U.S.
Key Tradeoff

- Capital-market effects are likely to be limited
- Main impact of IFRS adoption is likely to be on the cost side for firms and the U.S. reporting system
- Tradeoff between
  - One-time transition costs for firms and economy
  - Comparability benefits
    - Modest but accrue over much longer horizon
  - Recurring cost savings
    - Accrue mostly to multinational firms
    - Limited due to the fact that IFRS are generally not used for statutory and tax reporting
- Net effect for a given company or the U.S. as a whole is not obvious and depends on horizon and discount factor

Standard Setting Process
Is the Competition Argument Compelling?

- IASB would have a monopoly over standard setting
  - In general, monopolies tend to curb innovation, slow down innovation, and are prone to political lobbying
  - Having a choice between U.S. GAAP and IFRS would help limit those tendencies
  - But only to the extent that firms (within a country) can truly choose
- Competition of regional monopolies is less likely to be effective
- Capital- and product market forces are an important source of innovation
- Standard setters need to be responsive to need of preparers and users
Political Considerations

• IFRS adoption by the U.S. signals willingness to cooperate internationally
  – Substantial political risks from NOT adopting IFRS (“losing the seat at the table”)
• Countries have different goals for financial reporting given the differences in their institutional frameworks
  – They will likely influence the IASB towards their respective (and legitimate) goals
• Governance structure of IASB needs to be carefully considered
  – Recent changes: Monitoring Board
• Potential safeguard: National endorsement process
  – Likely slows down development of new standards and could lead to regional fragmentation and hurt comparability
• Additional U.S. disclosure requirements
  – Costly and can change firms’ reporting incentives, which hurts comparability

Future Scenarios for U.S. Reporting Standards

• Maintain U.S. GAAP
• Continued convergence between U.S. GAAP and IFRS
• Allow choice, but require reconciliation
• Unrestricted choice between U.S. GAAP and IFRS
  – Comparability argument against this option is not very convincing
• Adopt U.S.-specific IFRS
  – SEC/FASB overlay of interpretations and implementation guidance
  – Supplemental disclosure requirements
• Set conditional timetable to adopt IFRS
  – Two-stage process (endogenous transition)
• Create alternate I-GAAP (more hypothetical than others)
Implications of U.S. Decision for the EU

• U.S. adoption may have some comparability effects in the EU but they are muted for the same reasons
• U.S. could add specific disclosure requirements
  – These requirements could become a de-facto standard for firms and countries around the world
• Influence of the EU on IASB is likely to decrease
• My best guess (but not recommendation)
  – Continued convergence process between IASB and FASB
  – IFRS adoption by the U.S. in the near term appear unlikely
## Some Evidence from DHLV (2008)

<table>
<thead>
<tr>
<th>Model</th>
<th>Market Type</th>
<th>Control Variables</th>
<th>Dependent Variables</th>
<th>Specification</th>
</tr>
</thead>
<tbody>
<tr>
<td>M01</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>3 (Long-term, 2)</td>
</tr>
<tr>
<td>M02</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>2 (Long-term, 2)</td>
</tr>
<tr>
<td>M03</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>1 (Long-term, 2)</td>
</tr>
<tr>
<td>M04</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>0 (Long-term, 2)</td>
</tr>
<tr>
<td>M05</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>-1 (Long-term, 2)</td>
</tr>
<tr>
<td>M06</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>-2 (Long-term, 2)</td>
</tr>
<tr>
<td>M07</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>-3 (Long-term, 2)</td>
</tr>
<tr>
<td>M08</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>-4 (Long-term, 2)</td>
</tr>
<tr>
<td>M09</td>
<td>Domestic</td>
<td>Market Liberalization</td>
<td>Regional Integration</td>
<td>-5 (Long-term, 2)</td>
</tr>
</tbody>
</table>

**Note:** All models are estimated using OLS regression. 

---

**Control Variables:**
- Market Liberalization
- Regional Integration

**Dependent Variables:**
- Economic Growth
- Investment
- Trade

**Specification:**
- Long-term: 1, 2, 3, 4, 5
- Short-term: 0