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

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Keynote Presentation at the LSE MBS Conference

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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

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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

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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

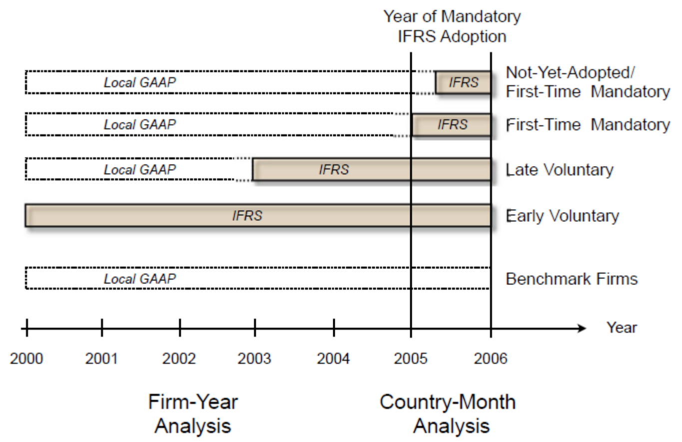
Challenges

- 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 policy makers (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

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



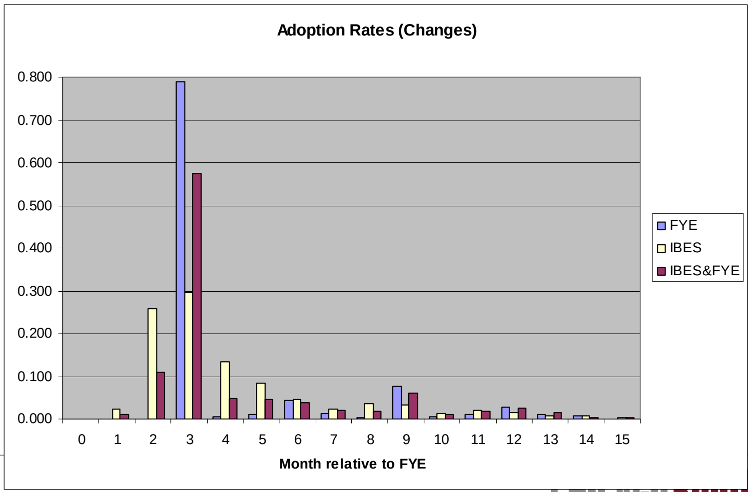
Evidence on IFRS Adoption around the World (Daske, Hail, Leuz and Verdi, 2008)

- 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

Adoption Rates for Identification



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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

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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

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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

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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

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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

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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)

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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

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Some Evidence from DHLV (2008)

TABLE 7

Cross-Sectional Analysis of the Liquidity Effects around the IFRS Mandate

(*Liquidity Factor* as Dependent Variable)	Country-Level Institutions as Conditional Variables					Conditioned on Industry Level
Independent Variables	Model 1: Rule of Law (1 = Stricter Enforcement)	Model 2: Membership in the European Union (1 = Yes)	Model 3: Aggregate Earnings Management (1 = More Transparent Earnings)	Model 4: Difference between Local GAAP and IFRS (1 = More Discrepancies)	Model 5: IFRS Convergence Strategy (1 = Yes)	Model 6: % of Voluntary IFRS Adopters (1 = Higher Percentage)
IFRS adopter types:						
(1) *Voluntary*	−3.04	11.72	−2.11	10.45	−6.05**	−4.17
	(−0.94)	(1.42)	(−0.54)	(1.24)	(−2.46)	(−1.32)
(2) *Voluntary* ∗ *Conditional Variable*	−2.85	−18.08**	−2.95	−15.77∗	31.30***	0.27
	(−0.61)	(−2.11)	(−0.60)	(−1.79)	(3.48)	(0.06)
Test of (1) + (2) = 0 [*p*-value]	[0.09]	[0.01]	[0.10]	[0.04]	[0.00]	[0.27]
(3) *Voluntary* ∗ *Mandatory*	**2.64**	**−4.05**	**−0.74**	**3.11**	**−5.39*** **	**−4.90***
	(1.11)	**(−1.18)**	**(−0.32)**	**(0.60)**	**(−3.25)**	**(−1.68)**
(4) *Voluntary* ∗ *Mandatory* ∗ *Conditional Variable*	**−8.66*****	**−0.67**	**−8.70*****	**−8.33**	**5.54**	**2.20**
	(−3.10)	**(−0.19)**	**(−3.13)**	**(−1.58)**	**(0.69)**	**(0.61)**
Test of (3) + (4) = 0 [*p*-value]	**[0.00]**	**[0.01]**	**[0.00]**	**[0.00]**	**[0.98]**	**[0.20]**
(5) *First-Time Mandatory*	**1.54**	**3.20***	**0.02**	**−2.69***	**−11.11*****	**−7.35*****
	(0.99)	**(1.91)**	**(0.01)**	**(−1.81)**	**(−7.71)**	**(−4.13)**
(6) *First-Time Mandatory* ∗ *Conditional Variable*	**−9.40*****	**−13.90*****	**−9.59*****	**−4.75****	**16.66*****	**5.48****
	(−5.12)	**(−7.09)**	**(−4.96)**	**(−2.54)**	**(8.21)**	**(2.21)**
Test of (5) + (6) = 0 [*p*-value]	**[0.00]**	**[0.00]**	**[0.00]**	**[0.00]**	**[0.00]**	**[0.28]**

(*Continued*)