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Financial Reporting under IFRS: Relevant for Investors, but does it Enhance Reliability and Comparability?

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Abstract

The transition toward the adoption of a new financial reporting model such as IFRS (International Financial Reporting Standards) raises many questions. For example, do IFRS meet their stated goals in terms of 1) enhancing the relevance of financial statements, 2) improving the quality of financial reporting and 3) facilitating comparability? In this paper, we review the evidence about these questions from other countries that have adopted IFRS. From this evidence, we draw some conclusions as to the impact of IFRS adoption on Canadian capital markets.

Résumé

L’adoption d’un nouveau référentiel comptable tel que les IFRS (International Financial Reporting Standards) soulève plusieurs questions. Par exemple, le référentiel IFRS va-t-il rendre les états financiers plus pertinents pour les investisseurs ? Va-t-il améliorer la qualité de l’information financière publiée ? Va-t-il faciliter la comparabilité des états financiers ? Dans cet article, nous nous attarderons à présenter sommairement les résultats de l’expérience vécue dans divers pays ayant adopté le référentiel IFRS. De là, nous tirerons quelques conclusions quant à l’impact anticipé pour les marchés boursiers canadiens suite à l’adoption des IFRS en 2011.

Introduction

The advent of global capital markets requires investors to compare firms across countries if they are to build efficient and well-balanced portfolios. In that regard, despite their well-publicized limitations and weaknesses, financial statements remain a critical resource for investors. Hence, the use of a common set of accounting standards by firms across countries should facilitate the task of analysts, investment managers and investors. The perceived need for harmonization and comparability has led to the emergence of International Financial Reporting Standards (IFRS) as the dominant template for financial reporting in most countries around the world, with Canada joining the parade in 2011. At that time, for organizations that are publicly accountable, standards enacted by the International Accounting Standards Board in London will replace Canadian-made standards.

The transition toward a new financial reporting model raises many questions. For instance, do IFRS meet their stated goals in terms of 1) enhancing the relevance of financial statements, 2) improving the quality of financial reporting, especially its reliability, and 3) facilitating comparability? In this paper, we review the evidence about these questions from other countries that have adopted IFRS, including the European Union in 2005. From this evidence, we draw some conclusions as to the expected impact of IFRS adoption on Canadian capital markets.

How can we know if accounting standards harmonization work?

In 2005, publicly listed entities from all countries comprising the European Union countries switched from their national accounting standards to IFRS for their consolidated accounts. The major argument underlying such a drastic move was that a common basis for financial reporting was essential to ensure economic and capital markets integration. At the time we wrote this article, the United States and Japan were the only large economies still adhering to locally-determined accounting standards, most of the world having switched over the IFRS (China has adopted a set of standards that is inspired by IFRS). In light of this trend, Canada’s Accounting Standard Board has decided that publicly accountable Canadian firms will have to report in accordance to IFRS in 2011.

In theory, the experience from firms that adopted IFRS, on a voluntary or mandatory basis, may provide some useful hints as to what Canadian firms and markets may experience from 2011 onward. However, in practice, assessing if IFRS meet their stated goals and objectives is difficult for several reasons. First, in many countries, the adoption of IFRS is accompanied by concurrent regulatory or institutional changes. For instance, in France, IFRS adoption closely followed the enactment of new corporate governance and market oversight regulations: therefore, it is difficult to disentangle if the observed investors’ reaction to the release of financial statements is an outcome of adopting IFRS or of the implementation of new regulations requiring more disclosure and better governance. Second, the wave of countries adopting IFRS is highly concentrated in time:

for example, all European Union countries mandated IFRS by 2005, which implies that all firms switched from domestic accounting standards to IFRS under the same favourable macro-economic conditions. Hence, did investors react to IFRS information or to underlying economic trends and news? Third, it is difficult to tease out the information contained in the accounting numbers themselves from the additional information provided in the notes. For these reasons, any discussion about the effectiveness or value of IFRS compared to other standard setting frameworks is tentative at best. Finally, and perhaps most importantly, IFRS is a symbolic label but its substance may vary across firms and countries. In other words, at the country level, there is much discretion in the implementation as well as in the enforcement of IFRS. Moreover, at the firm level, several choices available to management have a direct impact on the reported financial statements. With these caveats, we now review the available evidence.

Do IFRS translate into more relevant financial statements?

Over the years, standard setters in Canada and in the United States have narrowed down the focus of accounting standards to the informational needs of equity investors and, creditors. The move toward IFRS confirms the primacy of financial markets in the determination of accounting standards, with the relevance of financial statements being mostly defined in terms of how useful they are to equity investors. Such an approach to standard setting downplays the importance of accounting information for other stakeholders such as regulators, governments, employees, etc. Moreover, stewardship, or the use of accounting information for contractual purposes, is relegated to a secondary role in the determination of accounting standards.[1] Thus, while this evolution in the philosophy underlying standard-setting is debatable, we assess the impact of IFRS using its own self-proclaimed goal as a benchmark, i.e., providing investors with relevant information.

The relevance of accounting information can be evaluated through various means such as its impact on stock prices, on the accuracy of analyst forecasts and on investment decisions. First, with respect to stock prices, it appears that IFRS-based financial results map into how investors assess a firm's stock market value. For instance, there is evidence that the IFRS adjustments reported for 2004 are useful to investors' in their appreciation of a firm's stock market value (financial statements prior to 2005 prepared according to domestic standards needed to be reconciled with IFRS). Moreover, in the United Kingdom, firms reporting IFRS earnings that are lower than those computed according to UK GAAP are penalized by the stock market.[2]

Second, there is some evidence that a switch from domestic standards to IFRS has a modest positive impact on market liquidity and on the cost of equity capital. In other words, with the new information set at their disposal, investors find it easier to buy or sell securities. Such improvement in liquidity most likely results from the reduction in information asymmetry between investors and managers following the implementation of IFRS: higher quality financial reporting, greater transparency as well as enhanced oversight by analysts, auditors and directors from the use of a common reference in accounting all potentially contribute to this improvement in the information environment.[3] However, it is interesting to note that firms that voluntarily adopt IFRS ahead of the mandated year of adoption experience a stronger improvement in the liquidity of their stock and in their cost of capital than firms that only adopt IFRS at the required date. Therefore, it is unlikely that IFRS adoption alone drives the improvement in the information set that is available to investors: other regulatory or institutional changes probably take precedence.

Third, the use of IFRS information allows financial analysts to improve the accuracy of their forecasts. Hence, there is evidence of an increase in analyst forecast precision following IFRS adoption, especially for countries with high investor protection.[4] Moreover, initial reporting under IFRS led to a decrease in return synchronicity, implying that investors lost traditional benchmarks in assessing a firm's financial performance and probably engaged in noise trading.[5] However, once the new information was assimilated, synchronicity increased.[6] This increase in relevance for stock markets is observed for firms highly followed by analysts.

Fourth, investors react to the release to IFRS information by rebalancing their portfolios. More precisely, investors that rely more extensively on fundamental analysis or on accounting data (foreign investors, value investors) use IFRS-derived financial statements to sell or buy specific securities, much more so than when just domestic standards were used.[7]

Finally, based on prior research in different accounting setting, we can expect IFRS adoption to affect Canadian stock markets. For instance, contrary to Canadian GAAP, asset revaluation is allowed under IFRS and UK GAAP.[8] Upward revaluations by UK firms are associated with positive future performance and with higher stock prices for the revaluation year. Furthermore, the level of details in financial reporting under IFRS is higher than under Canadian GAAP. Under IFRS, income statement items are detailed in terms of nature (depreciation, purchases of materials, transport costs, employee benefits, advertising costs) and function (cost of sales, cost of distribution). This should provide relevant information to market participants.

Overall, we may infer that IFRS financial statements do provide relevant information to investors. However, the effect is relatively modest, despite the wide heterogeneity in financial reporting standards prior to IFRS adoption. Moreover, one must keep in mind all the limitations mentioned above before attributing all these effects to IFRS-derived earnings and other figures.

Canada’s current accounting standards are extremely close to IFRS, which was not the case for many adopting countries. Therefore, its impact on stock market valuations and investors’ decisions is likely to be minimal or modest at best.

Do IFRS affect accounting quality? (i.e., reliability or representational faithfulness)

IFRS provide managers with extensive discretion in financial reporting. For instance, while U.S. GAAP contain numerous rules and bright lines to specify when and when not to use a particular standard, IFRS defer more to the judgment of professionals involved in the preparation of financial statements. Moreover, in many respects, IFRS are much less conservative than current Canadian and U.S. GAAP, the possibility to reevaluate capital assets being a key illustration. Finally, at the time of adoption, IFRS allows managers to make several choices as to which standard they want to exempt their firm from.

Anecdotal evidence from various countries suggests that the adoption of IFRS typically leads to an increase in the reported levels of earnings or equity. Garcia, Garcia and Pope (2009)[9] conduct a large scale study on the effect of mandated IFRS adoption on earnings quality. They assess the levels of discretionary accruals pre- and post-IFRS. Overall, they conclude that at both the country and firm levels, the adoption of IFRS did not translate into an improvement of the quality of financial reporting. They conclude that IFRS adoption by itself is not sufficient to guarantee high financial reporting quality. Effective enforcement by institutional and market forces are necessary to ensure that IFRS adoption leads to an improvement in the reliability of financial statements.

At the end of the day, do IFRS enhance comparability across countries?

According to the IASB, the widespread adoption of global accounting standards, such as IFRS, enhance financial statements comparability across countries, thus facilitating global investing. Is it the case? In that regard, the evidence is troublesome. Pursuing their analysis, Garcia, Garcia and Pope[10] rank European countries that have adopted IFRS on the extent of their firms' earnings management, i.e., the magnitude of discretionary accruals. Pre-IFRS, firms from countries such as Greece, Austria, Germany, Spain, Portugal and Italy rank among the most likely to manage their earnings, i.e., exhibit high levels of discretionary accruals. In contrast, firms from countries such as the United Kingdom, Sweden or Ireland show financial reporting that more closely map their underlying economic performance, with managers exercising less discretion in determining the direction of financial reporting.

Post-IFRS, the rankings of these countries do not substantially change. In other words, despite the change in financial reporting regime toward IFRS, earnings quality at the aggregate level does not vary substantially. Therefore, while in appearance, all firms from European Union countries present their financial statements in a format that looks comparable, the numbers reported in these financial statements are not necessarily more comparable than they were prior to the adoption of IFRS: major differences in measurement, recognition, audit and market monitoring practices still remain post-IFRS. Hence, beyond IFRS adoption, its actual implementation and the enforcement of such implementation play a critical role in ensuring that informational benefits from IFRS flow to investors and other market participants.

Overall, changing the form of financial reporting does not necessarily imply that its underlying content is improved or modified. The IASB's goal of facilitating international harmonization and comparability of financial statements still appears to be several years ahead of us.

So, what is in store for Canada?

From international evidence regarding the adoption of IFRS, we can predict that its impact on Canada's financial markets is likely to be modest. On one hand, the advent of IFRS may improve the information set that is available to market participants and, therefore, enhance the relevance of financial statements. Such effect is likely to be driven by incremental disclosure. However, in many cases, it is also conditional upon the discretionary choices available to management (e.g., reevaluations of property, plant and equipment under IAS 16). On the other hand, firms that had aggressive financial reporting strategies pre-IFRS are likely to remain that way post-IFRS. Moreover, in light of the heterogeneity in the implementation of IFRS around the world and even within countries, the comparability of Canadian firms' financial statements with financial statements from other countries' firms is unlikely to be significantly enhanced. In this regard, what is most critical is the intensity of auditing, regulatory and market monitoring to which Canadian firms are subjected to: the adoption of IFRS in itself does not change these dynamics. In that context, is the cost of switching over to IFRS justified? Only time will tell how conversion costs and benefits even out.

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[6] Synchronicity refers to how a given firm's or industry's stock returns relate to overall stock market returns. A weak relation implies that the valuation of individual firms or industries is mostly driven by firm- or industry-specific information (low synchronicity). A strong relation implies that individual or industry stock returns are closely aligned with overall market trends (high synchronicity).

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[10] Idem.