INTERNATIONALIZATION OF ACCOUNTING SYS EMS AND GLOBAL FINANCE: A BRIEF REVIEW OF IFRS ADOPTION AND ITS IMPACT ON E CAPITAL MARKET

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Abstract

Adopting International Financial Reporting Standards is the current trend in harmonization of national accounting systems to enhance comparability of financial reporting. The expected benefits of using a single set of standards throughout the world, however, are questionable due to inherent differences in economic and political conditions across countries. This article summarizes recent research on the real benefits of IFRS adoption on the capital market and provides recommendations for Vietnam in adjusting its current accounting system.

Key words: *International accounting system capital market, IFRS*

1. Introduction

Since the end of the Second World War, the degree of economic globalization has increased steadily. Along with growing international trade, foreign direct investments, globalized production activities, the capital markets have also becoming increasingly globalized. Major financial markets have been deregulated and the link between domestic and world financial markets is tightened to enable easier capital movement across countries. Corporate stocks and bonds are listed abroad and securities are priced according to international rather than domestic factors (Wheatley 1988). Within this context, the existence of major financial reporting differences is considered to hinder the globalization process. The requirement, therefore, is to harmonize national accounting systems to ensure comparable accounting information quality as well as to enhance comparability of financial reporting to improve international capital allocation decisions.

Early harmonization activities were to have firms approaching international markets to lower cost of capital to adopt dual financial reporting systems (the domestic as well as those of countries where the firm is listed), which greatly raises the cost of preparation for these firms. Since the reconstitution of the International Accounting Standard Board (IASB) in 2001, the biggest and most successful attempt to harmonize accounting

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systems so far is the introduction and adoption of the International Financial Reporting Standards (IFRS) around the world. The IFRS's objective is to develop a single set high quality of accounting standards to enhance global accounting consensus in order to improve accounting information quality and comparability. Currently, almost 120 countries have permitted or required the use of IFRS while the remaining economies have set up timelines to adopt or converge with IFRS in the foreseeable future.[1] Mandatory convergence with or adoption of IFRS results from an expectation on the part of regulatory bodies that the use of IFRS enhances accounting information comparability, improves financial reporting quality and corporate transparency to consequently benefit investors (e.g., EC Regulation No. 1606/2002). However, accounting is affected by its environment, including cultural, legal factors as well as business organization and ownership patterns (Gray 1988; La Porta et al. 1998; Hofstede 2001; Leuz et al. 2003). Country differences cause variations in not only accounting rules but also accounting practices across countries. Consequently, whether or not intended benefits of IFRS exist in the real world is an empirical question. As financial reporting is influenced by both regulations and the application of such regulations, simply mandating regulations (in this case, IFRS) may not be enough to change the current reporting landscape. While recognizing the success of developing a comprehensive set of accounting rules to be used globally, researchers have expressed concerns over the intended benefits of such global rules as it is very likely that an uniform set of standards will not produce uniform financial reporting because of inherent differences in countries' market and political forces (Ball 2006). This article provides a brief review of the current empirical results attesting to the possible benefits of IFRS adoption in order to evaluate the net benefit of current international harmonization tendency. Based on the evaluation, suggestions on the more effective approach will be provided.

2. Expected benefits of unifying accounting standards

One important quality of accounting information is comparability. In the growing globalization of financial markets, comparability of financial reporting across firms in different countries facilitates the movement of funds from one country to another to increase capital allocation efficiency and reduce costs of capital for firms. If firms and/or countries use different accounting techniques, the resulting informational externalities may create costs on users due to the lack of comparability. If they are to internalize those costs, it would be more advantageous for them to switch to a uniform set of rules to minimize the costs (Ball 2006).

Arguments supporting the development and mandatory adoption of IFRS are based on the premise that IFRS improve financial reporting quality and the use of a single reporting system such as IFRS enable comparison of firm performance across countries. IFRS is considered to be more capital market-

[1] See IFRS Foundation and IASB. July 2011. Who we are and What we do. *A guide to the IFRS Foundation and IASB, downloaded from www.ifrs.org on September 22, 2011.*

oriented, more comprehensive with respect to disclosures. Higher financial reporting quality alleviates the information assymmetry problem, reduces adverse selection problem and reduces the estimation risk. Even when IFRS is not considered to be superior than the original national accounting system, more comparable financial statements induced by the use of a single set of accounting rules enable a better comparison across firms, making financial information more useful. Consequently, the expected capital market benefits of adopting or converging with IFRS are: (i) increase market liquidity as investors are more informed and incur less costs comparing firm performance and therefore, more willing to trade. Reducing international accounting differences means removing certain barriers to cross-border acquistions and divestitures to increase takeover premiums for investors; (ii) reduce costs of capital thanks to lessening information assymmetry. Increased disclosures will reduce the level of information assymmetry between potential buyers of shares and share issuers, and therefore, will reduce the level of discount at which firm shares are sold, which means lowering the cost of equity; (iii) improve equity valuation as financial reporting is now more informative and useful for valuation decision. Lowering the cost of processing information likely increases the efficiency with which information is incorporated in stock prices, which means market efficiency will be improved.

There are, however, arguments against the effectiveness of adopting IFRS. While accounting standards can influence the quality of financial reporting, they are neither the only nor most important factor. As any other set of accounting rules, IFRS allow for a great degree of management discretion. The application of accounting rules, therefore, plays a greater role in determining reporting quality. Due to differences in cultural, political and social values, it is expected that there are variations of accounting practices across countries. Adopting IFRS per se, therefore, may not produce a material impact on information quality. Consequently, capital market impacts identified in the previous paragraph could be minimal.

3. Empirical evidence on the benefits of using uniform accounting standards

The adoption of IFRS by the European Union in 2002, effective for 2005 financial statements marked an important development in international accounting history. Since then, international accounting harmonization has been accelerated in many countries. At the same time, researchers have devoted great effort in evaluating the real costs and benefits of IFRS harmonization. Given the significance of accounting changes in the EU when IFRS is adopted, EU countries have been the most common setting selected for research on IFRS adoption benefits.

One important expected benefit of IFRS adoption is lowering cost of capital for firms. With increased and more comparable disclosure, the information asymmetry problem will be lessened, leading to a reduced level of information risk and therefore, a lower cost of capital. An early study of the impact of IFRS adoption on costs of capital in the EU was conducted specifically for the financial industry by Palea (2007). The study shows that the adoption of IAS/IFRS as directed by

the EU's Regulation 1606/2002 has, indeed, resulted in a lower cost of capital. The purpose of fostering a cost-efficient functioning of the capital market for firms, therefore, could be considered to have been accomplished.

Another expected benefit of IFRS is improved value relevance of accounting information. When IFRS can eliminate accounting choices that are less reflective of firm performance but rather provide a higher degree for management's discretion, IFRS adoption will result in less earning management and therefore, better valuation. This hypothesis is supported in Barth et al. (2008). The authors document higher association between accounting numbers and stock price for international accounting standards adopters. However, the research design using voluntary adopters is unable to isolate the impact of IAS and firms' reporting incentives and environment on improved valuation relevance.

Limiting to only one country in the EU, Christensen et al. I°'s (2007) examine changes in market valuation and costs of capital upon mandatory adoption of IFRS for a sample of UK firms. Differently from other national GAAP, UK GAAP is considered to be high quality accounting practices and therefore, the switch to IFRS may only improve the comparability of financial statements with foreign firms rather than increase the level of disclosure. Results show that there are variations in the capital market impacts associated with the adoption across firms, suggesting that the intended benefits cannot be realized for all but rather, the adoption of an uniform set of accounting rules bring about both losers and winners. Dependent upon prior-IFRS reporting environment, the mandatory adoption of or convergence with IFRS imposes differential costs across firms and countries. It may introduce substantial changes to the valuation of balance sheet items as well as the magnitude of revenues and costs recognized in some firms while not in others. Also, it requires a new set of disclosures which is greater than the original requirements in some countries but not in others (Christensen et al. 2007), indicating that the realized impacts vary with the quality of financial reporting before IFRS.

An early study of the impacts of IFRS adoption on the capital market for a large sample of countries is Daske et al. 's (2008) examination of how IFRS adoption affects market liquidity, cost of capital and Tobin's q for firms in 26 countries around the time of mandatory adoption of IFRS. The use of mandatory adoption setting avoids the problem of selection bias and isolates the impact of accounting rules apart from reporting incentives. The study documents evidence that, when IFRS is adopted, market liquidity increases, costs of capital are lowered and equity valuations are improved. Interestingly, however, such benefits seem to only occur in countries where firms have incentive to be transparent and where legal enforcement is strong, indicating a joint effect of both regulations and enforcement. In order to estimate the significance of firm incentive on the capital effects of IFRS adoption, the researchers compare the improvement in market liquidity, cost of capital and Tobin's q between a group of firms where IFRS is adopted voluntarily and another group where IFRS adoption is mandated. While applicable

accounting rules are the same for the two groups, reporting incentives differ between them. The voluntary adopter group has an incentive to switch to IFRS to internalize the advantages of using a high quality uniform accounting standards. The mandatory adopters, however, have no such incentive but the adoption is rather imposed on them. The more pronounced effects present in the group of IFRS voluntary adopters caution the premise that IFRS mandate would result in an advantageous capital market impacts. This documented evidence is consistent with researchers' contention that IFRS implementation is likely heterogeneous across countries because reporting outcomes greatly influenced by reporting incentives, which are in turn shaped by national market and institutional characteristics (Ball 2006). In a more recent study, Li (2010) examines specifically the impact of IFRS adoption on the cost of capital. The author finds a significant drop in the cost of capital after mandatory IFRS adoption. Enhanced disclosures and improved information comparability are two mechanisms behind such drop. However, similar to Daske et al. 's (2008) results, the reduction is only present in countries with strong legal enforcement. Using a different approach, Armstrong et al. (2010) look at investors' reaction to news about IFRS adoption in the EU. An advantage of this approach over that employed by Daske et al. (2008) or Li (2010) is that the market reaction will reflect the net benefits of IFRS adoption rather than specific benefits. Therefore, consideration of any costs associated with IFRS adoption is also incorporated. As share price reflects investors' perception about accounting quality and information risk, share price will increase upon IFRS adoption news is released, should the adoption is expected to improve accounting information quality. Positive reaction is documented upon adoption news and is more pronounced for firms with lower quality pre-adoption information or firms with higher pre-adoption information asymmetry such as banks. Negative reaction, however, is found in code law jurisdictions, indicating a concern over the enforcement of IFRS in those countries.

Researchers have expressed concerns over the amplification of the impact a uniform set of accounting rules will have on the capital market. A reporting outcome is a product of both accounting mandates and the practice and application of such mandates. Unifying accounting rules, therefore, will not ensure uniform financial reporting. Nobes (1998) posits that a country's financing system is a major determinant of its accounting system since it influences the purpose of accounting. Disclosure quality in stock market based economies such as UK or USA is frequently considered better than in bank financed economies such as Germany or Italy. Furthermore, as any other accounting regulation does, IFRS offers rooms for management's discretion in valuation as well as disclosure. How management uses its decision power is influenced by their reporting incentives as well as the culture, legal system they are from. For example, Leuz et al. (2003) find legal environment influences a firm's earnings management behavior while Han et al. (2008) and Nabar and Boonlert-U-Thai (2007) conclude that cultural factors affect a firm's accounting practice. In addition,

the quality of disclosure is determined by the accountability to investors (Sellhorn and Gornik-Tomaszewski 2006). Consequently, the same set of accounting rules may translate into different versions of accounting reports, dependent upon the 'translators' - accountants. As such, it is expected that international differences in financial reporting practice and quality continue to exist when the economic, cultural and political influences on financial reporting remain local. Comparability of accounting information, therefore, could not be achieved just by adopting IFRS.

4. Conclussions and suggestions for Vietnam

Experience of the EU and other countries in harmonizing their accounting systems towards a single set of rules has shown to create a positive impact on the capital market. With the increased market liquidity, reduced cost of capital and improved security valuation, capital will be allocated to more efficient uses. The degree of success, however, is dependent upon economic and political underpinnings. As such, a full IFRS adoption, even though considered as a more cost effective approach in developing domestic accounting rules, may not be able to achieve the intended level of comparability and create higher information processing costs for investors. Converging with IFRS to take into account country specific characteristics is an alternative. However, aligning the national systems with IFRS is costly itself. Given the current development stage of Vietnam, a partial adoption or converging with IFRS seems to be a better choice to make sure that better financial reporting requirements are implementable and effective. Furthermore, converging with IFRS clearly recognize that there exists international differences across countries, avoiding a misconception among investors that a uniform standards create uniform financial reporting. Information costs and information risks associated with uneven implementation of uniform accounting standards could be lessened, thanks to users' greater awareness of such costs[2].

Financial reporting is influenced by legal environment. A good set of accounting rules will not translate into high quality accounting information if legal enforcement is weak and outsiders' right is not sufficiently protected under the law. Thus, in order to improve accounting quality, Vietnam's legal system should also be renovated to enhance implementability and protect investors' property.

Also, as research evidence shows, financial reporting quality does not only depend on accounting standards but also reporting incentives. The greater role the capital market plays in the economy, the higher the reporting incentive and the better the reporting quality. This seem-to-be chicken and egg problem between the capital market development and accounting information quality suggests that while renovating the accounting system, Vietnam also need to put its best efforts in increasing the significance of the capital market. And both accounting system and capital market development should go hand in hand, without either of them lagging behind.

[2] When IFRS is adopted, investors may be misled into believing that uniformity of standards reduces international differences in financial reporting more than actually the case (Ball 2006)

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