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Measuring the impact of international reporting standards on market performance of publicly traded companies

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ABSTRACT

The decision whether to require publicly traded companies to adopt International Financial Reporting Standards (IFRS) remains in flux. In 2008, the US Securities and Exchange Commission proposed a roadmap leading to complete acceptance of IFRS in the US. With the potential replacement of US GAAP with IFRS in the near future, understanding the impact of IFRS on corporate financial reporting is more important than ever. This study examines two factors which are critical considerations in the decision to accept or not to accept IFRS in the US: How different is financial statement information derived under IFRS from information derived under US generally accepted accounting principles (GAAP); and how much incremental information value, if any, is provided by IFRS over US GAAP? The present study extends prior research by examining concurrently both differences and their impact on market performance. Findings of this study support the view that differences on financial statement results between IFRS and US GAAP are not significant, thus, supporting proponents of adoption of IFRS in the US, after which all US publicly traded companies would use IFRS and not US GAAP.

1. Introduction

Use of International Financial Reporting Standards (IFRS) is a major financial reporting issue worldwide and the subject of extensive academic research (e.g. Barth, 2008, Blanco & Osma, 2004, Daske, Hail, Leuz, & Verdi, 2008, Heino and Fontana, 2011, Hope, Jin, & Kang, 2006, Pownall & Schipper, 1999, Rees & Weisbach, 2002, Reineking, Chamberlain, Rudolph, & Smith, 2013, Smith, 2012, Wang & Smith, 2009). Pivotal events of the past decade include acceptance of IFRS for financial reporting in the European Union in 2005 and the US Securities and Exchange Commission's decision in 2007 to accept IFRS for financial reporting by non-US firms trading in US markets. In 2008, the Commission proposed a timeline leading to eventual acceptance of IFRS for all US publicly traded companies, foreign and domestic; this timeline was later revised in 2010. According to the timeline, complete acceptance of IFRS in the US may occur as early as 2015.

Corporate management is accountable for the quality and reliability of financial statements. The increasing globalization of business, along with improvements in technology, has led to a globalization of the capital markets and increased foreign direct investment. Understanding the potential impact of IFRS on a company's accounting process is critical to accountants, auditors, corporate management, investors, lenders, financial analysts, regulators, and others connected to corporate financial reporting. This has led to increasing inclusion of an international accounting course in many university accounting programs, and corresponding development of international accounting textbooks (e.g. Doupnik & Perera, 2011; Saudagaran & Smith, 2013).

The pivotal question remains: Is acceptance of IFRS in the US inevitable? Smith (2008) refers to adoption of IFRS as an 'unstoppable juggernaut.' Even after much public discussion and notable academic research, the answer remains unclear. However, assuming the potential replacement of US generally accepted accounting principles (GAAP) with IFRS in the near future, understanding the impact of IFRS on corporate financial reporting is more important than ever. The overall purpose of this paper is to provide a better understanding of IFRS and its impact on corporate financial reporting in relation to US generally accepted accounting principles. Specifically, this paper addresses two questions which are critical considerations in the decision to accept or not to accept IFRS in the US: (1) How different is financial statement information derived under IFRS from information derived under US GAAP and, (2) how much incremental information value, if any, is provided by IFRS over US GAAP? No prior study has examined concurrently both differences and impact on market performance.

To address these questions, we hand-collect financial data for 64 European Union firms that list stock on the New York Stock Exchange in both 2005 and 2006. We limit our sample to the years 2005 and 2006 in order to fall between two important rulings made by the EU and United States. First, beginning in 2005, all EU firms were required to use IFRS-based financial reports. Second, in 2007, the US Securities

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and Exchange Commission (SEC) ruled that non-US firms are no longer required to reconcile IFRS with US GAAP when reporting earnings (SEC, 2007). Therefore, 2005 and 2006 represent unique years in which the EU firms trading in US markets reported financial statements using two different standards: IFRS and US GAAP.

We exploit this dual-reporting regime to evaluate the extent to which key financial statement numbers differ across IFRS and US GAAP. We find that over 67% of our sample firms report higher net income when reporting under IFRS than GAAP. However, the average difference in revenue, net income, total assets, total liabilities, and shareholders equity across the two reporting regimes is insignificantly different from zero. For the EU firms in our sample, reported earnings per share (EPS) are the only key financial figure that significantly differs across IFRS and US GAAP. Under IFRS, the mean EPS (basic) is $14.68 but falls to $7.39 when reporting under US GAAP. To better understand the differences (or lack thereof) between IFRS-reported and US GAAP-reported financial numbers, we also collect and summarize the primary reconciliation categories cited by the firms in our sample. In each Form 20-F, the average firm reports 7.5 reconciliations, with those related to "Intangible Assets, Impairments, and Goodwill" being the most frequent.

Financial statement items do not appear to differ significantly between IFRS and US GAAP. However, the value-relevance of IFRS data to market participants in the US is still an empirical question. Each EU firm in the sample is matched to a corresponding US firm based on year, industry, firm performance, and size and compares long-run abnormal returns between groups. No evidence is found that 12-month abnormal returns are different for EU firms providing both IFRS and US GAAP information, compared to US firms reporting only US GAAP. Market participants do not place a premium on IFRS-based financial information, supporting the view that accounting quality and disclosure levels under IFRS are relatively equal to those under US GAAP.

2. Literature review

In 2001, the International Accounting Standards Board (IASB) was created by its predecessor, the International Accounting Standards Committee (IASC). The IASC was itself formed in 1973. The parent body of the IASB is the IASC Foundation. The organizational structure of the IASB resulted from a strategy review carried out by the Board of the International Accounting Standards Committee. Standards released by the IASB are designated International Financial Reporting Standards. In the past decade, the IFRS transitioned from being little used to what is now the world's dominant set of accounting standards (Rezaee, Smith, & Szendi, 2010).

The US Securities and Exchange Commission revised its rules in December 2007 permitting non-US companies to include in their SEC filings financial statements without reconciliation to US GAAP if the financial statements are prepared in accordance with IFRS as issued by the International Accounting Standards Board (IASB). Many regard this as a historic event in US financial reporting, as acceptance of IFRS removes a major obstacle for foreign private issuers to enter and to remain in the US markets (Deloitte — Federation Schools of Accountancy, 2008; Gibson, Dunn, and Crutcher, LLP, 2008). Street and Linthicum (2007) indicated that the SEC's invitation to comment offered an excellent opportunity for academics to apply their research and expertise to help shape the future of US GAAP and IFRS, and thereby the broader global capital markets.

The US's largest accounting professional organization, the American Institute of Certified Public Accountants (AICPA), has long advanced the goal of one set of high-quality globally accepted accounting standards among public companies worldwide and preparing US CPAs for use of IFRS. Towards this end, the AICPA initiated an IFRS Certificate Program in 2011 to increase member familiarity with IFRS (AICPA, 2011a).

The SEC appears close to accepting IFRS, not just for non-US companies trading in the US stock market but for US-based companies, too. Business leaders encouraging acceptance of IFRS include John Thain, CEO of the New York Stock Exchange, and Paul Volcker, former Federal Reserve Chairman (White, 2007). After her appointment in 2009, SEC Chairperson Mary Schapiro, expressed misgivings about the US adoption of IFRS and her unwillingness to be locked into the timetable put forward by her predecessor (WebCPA, 2009). Despite misgivings expressed by the SEC chairperson, FASB Chairman Robert Herz said that the US should consider adopting IFRS in the next three to five years even if all differences between US GAAP and IFRS are not resolved (Pickrell, 2009). Other findings regarding the adoption of IFRS echo such mixed sentiments. According to a 2011 survey published by the AICPA, almost 54% of current CPAs support the adoption of IFRS. Conversely, researchers who recently surveyed individual investors found that they are satisfied with the accounting standards model currently in place and have no desire to switch to IFRS (McEnroe & Sullivan, 2011).

While most CPAs (54%) support the optional adoption of IFRS standards, many (44%) are delaying IFRS preparation until the SEC reaches a decision on incorporating IFRS standards into US reporting requirements (Journal of Accountancy, 2011). The IFRS adoption complexities have led to the term "condorsement", which combines convergence of standards by "endorsing them one standard at a time into US GAAP" (WebCPA, 2011). Condorsement is favored by FASB Chair Leslie Seidman as a potential way to reconcile the differences between US GAAP and IFRS.

Although segments of the financial community continue to prevaricate on the issue, prior research suggests that the adoption of IFRS yields specific benefits. Spence (1973) uses signaling theory to demonstrate why companies adopt IFRS in international capital markets (Tarca, 2004). Information asymmetry and agency problems are probably lessened after adoption of IFRS, as insiders face greater risk of legal action by minority shareholders (Hope et al., 2006). IFRS require greater disclosure than that required by most countries' domestic accounting standards (Ding, Hope, Jeanjean, & Stolowy, 2006). The study by Rees and Weisbach (2002) indicates that greater investor protection associated with IFRS leads to improve stock price. The uniform reporting standards provided by multinational adoption of IFRS lower the costs of financial statement reconciliation associated with multinational equity (stock) listings (Biddle & Saudagaran, 1989) and potentially promote economic development (Hope et al., 2006). Hellman (2011) found a research opportunity created by Sweden's voluntary adoption of IFRS during 1991–2004. Empirical results of the study suggest that a 'soft' adoption of IFRS in Sweden provided firms discretion that was used for earnings management purposes.

Prior research by Barth (2008), Ball (2006), and Nobes (2006) evaluate the feasibility of convergence to IFRS, including the potential advantages of producing more accurate, timely, and complete financial information, removing international differences in accounting standards, and eliminating impediments to the global capital markets. Impediments to IFRS convergence examined in these studies include persistence of international differences under IFRS, the existence of market, legal, and political differences, and IFRS enforcement issues (Rezaee et al., 2010).

Mandatory IFRS adoption within the European Union has allowed researchers to uncover interesting findings with regard to domestic standard comparison. Aharony, Barniv, and Falk (2010) discovered that the valuation of goodwill, research and development expenses, and asset revaluation were increased in regard to value relevance to equity security investors. Research by Armstrong, Barth, Jagolinzer, and Riedl (2010) compared pre-IFRS adoption data with post-IFRS adoption data and found that investor reaction to adopting firms was generally positive. Research by Byard, Li, and Yu (2011) found that analysts' forecast errors and dispersions were lessened during the period of IFRS adoption in those European countries with strong enforcement regimes. Another study determined that mandatory