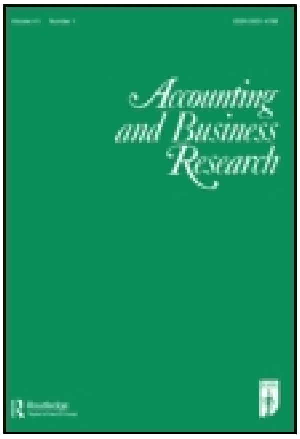

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International Financial Reporting Standards (IFRS): pros and cons for investors

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Abstract—Accounting in shaped by economic and political forces. It follows that increased worldwide integration of both markets and politics (driven by reductions in communications and information processing costs) makes increased integration of financial reporting standards and practice almost inevitable. But most market and political forces will remain local for the foreseeable future, so it is unclear how much convergence *in actual financial reporting practice* will (or should) occur. Furthermore, there is little settled theory or evidence on which to build an assessment of the advantages and disadvantages of uniform accounting rules within a country, let alone internationally. The pros and cons of IFRS therefore are somewhat conjectural, the unbridled enthusiasm of allegedly altruistic proponents notwithstanding. On the 'pro' side of the ledger, I conclude that extraordinary success has been achieved in developing a comprehensive set of 'high quality' IFRS standards, in persuading almost 100 countries to adopt them, and in obtaining convergence in standards with important non-adopters (notably, the US). On the 'con' side, I envisage problems with the current fascination of the IASB (and the FASB) with 'fair value accounting'. A deeper concern is that there inevitably will be substantial differences among countries in implementation of IFRS, which now risk being concealed by a veneer of uniformity. The notion that uniform standards alone will produce uniform financial reporting seems naive. In addition, I express several longer run concerns. Time will tell.

1. Introduction and outline

It is a distinct pleasure to deliver the 2005 PD Leake Lecture, and I sincerely thank the Institute of Chartered Accountants in England and Wales (ICAEW) for inviting me to do so. PD Leake was an early contributor to a then fledgling but now mature accounting literature. His work on goodwill (Leake, 1921a,b) stands apart from its contemporaries, so it is an honour to celebrate the contributions of such a pioneer. My introduction to Leake's work came from a review article (Carsberg, 1966) that I read almost 40 years ago. Ironically, the review was published in a journal I now co-edit (*Journal of Accounting Research*), and was written by a man who later became a pioneer in what now are known as International Financial Reporting Standards (the subject of this lecture), and with whom I once co-taught a course on International Accounting (here in London, at London Business School). It truly is a small world in many ways – which goes a long way to explaining the current interest in international standards.

International Financial Reporting Standards (IFRS) are forefront on the immediate agenda because, starting in 2005, listed companies in European Union countries are required to report consolidated financial statements prepared according to IFRS. At the time of speaking, companies are preparing for the release of their first full-year IFRS-compliant financial statements. Investors have seen interim reports based on IFRS, but have not yet experienced the full gamut of year-end adjustments that IFRS might trigger. Consequently, the advantages and disadvantages of IFRS for investors (the specific topic of this lecture) are a matter of current conjecture. I shall try to shed some light on the topic but, as the saying goes, only time will tell.

1.1. Outline

I begin with a description of IFRS and their history, and warn that there is little settled theory or evidence on which to build an assessment of the advantages and disadvantages of uniform accounting rules within a country, let alone internationally. The pros and cons of IFRS therefore are somewhat conjectural, the unbridled enthusiasm of allegedly altruistic proponents notwithstanding. I then outline my broad framework for addressing the issues, which is economic and political.

On the 'pro' side of the ledger, I conclude that extraordinary success has been achieved in developing a comprehensive set of 'high quality' standards and in persuading almost 100 countries to adopt them. On the 'con' side, a deep concern is that the differences in financial reporting quality

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that are inevitable among countries have been pushed down to the level of implementation, and now will be concealed by a veneer of uniformity. The notion that uniform standards alone will produce uniform financial reporting seems naïve, if only because it ignores deep-rooted political and economic factors that influence the incentives of financial statement preparers and that inevitably shape actual financial reporting practice. I envisage problems with the current fascination of the IASB (and the FASB) for 'fair value accounting'. In addition, I express several longer run concerns.

2. Background

2.1. What are IFRS?

IFRS are accounting rules ('standards') issued by the International Accounting Standards Board (IASB), an independent organisation based in London, UK. They purport to be a set of rules that ideally would apply equally to financial reporting by public companies worldwide. Between 1973 and 2000, international standards were issued by the IASB's predecessor organisation, the International Accounting Standards Committee (IASC), a body established in 1973 by the professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom and Ireland, and the United States. During that period, the IASC's rules were described as 'International Accounting Standards' (IAS). Since April 2001, this rule-making function has been taken over by a newly-reconstituted IASB.[1] The IASB describes its rules under the new label 'International Financial Reporting Standards' (IFRS), though it continues to recognise (accept as legitimate) the prior rules (IAS) issued by the old standard-setter (IASC).[2] The IASB is better-funded, better-staffed and more independent than its predecessor, the IASC. Nevertheless, there has been substantial continuity across time in its viewpoint and in its accounting standards.[3]

2.2. Brave New World

I need to start by confessing substantial ignorance on the desirability of mandating uniform accounting, and to caution that as a consequence much of what I have to say is speculative. There simply is not much hard evidence or resolved theory to help.

This was an unsettled issue when I was an accounting student, over 40 years ago. A successful push for mandating uniformity at a *national* level occurred around the turn of the twentieth century. National uniformity was a central theme of the first Congress of Accountants in 1904.[4] A century later, there is an analogous push for mandating uniformity at an *international* level, but in the meantime no substantial, settled body of evidence or literature has emerged in favour – or against – uniformity in accounting standards, at least to my knowledge.[5]

There thus is good reason (and, I will argue below, some evidence) to be sceptical of the strong claims that its advocates make for a single global set of accounting standards. So while this means Europe's adoption of IFRS is a leap of faith, it also means it is a Brave New World for commentators on IFRS, myself included. I therefore caution that the following views are informed more by basic tenets of economics (and some limited evidence) than by a robust, directly-relevant body of research.

2.3. Some thoughts on the role of mandatory uniform accounting standards

IFRS boosters typically take the case for mandatory (i.e., required by state enactment) uniform (i.e., required of all public companies) accounting standards as self evident. In this regard, they are not alone: in my experience, most accounting textbooks, most accounting teachers and much of the accounting literature are in the same boat. But the case for imposing accounting uniformity by fiat is far from clear. Some background analysis of the economic role of mandatory uniform accounting standards, one hopes, will assist the reader in sorting through claims as to the pros and cons of the European Union mandating of IFRS.

Voluntary standards. The fundamental economic function of accounting standards is to provide 'agreement about how important commercial transactions are to be implemented' (Ball, 1995:19). For example, if lenders agree to lend to a company under the condition that its debt financing will not exceed 60% of tangible assets, it helps to have agreement on how to count the company's tangible assets as well as its debts. Are non-cancellable leases debt? Unfunded health care commitments to employees? Expected future tax payments due to transactions that generate book income now? Similarly, if a company agrees to provide audited profit figures to its shareholders, it is helpful to be in agreement as to what constitutes a profit. Specifying the accounting methods to be

[1] The International Accounting Standards Committee (IASC) Foundation was incorporated in 2001 as a not-for-profit corporation in the State of Delaware, US. The IASC Foundation is the legal parent of the International Accounting Standards Board.

[2] For convenience, I will refer to all standards recognised by the IASB as IFRS.

[3] The IASB account of its history can be found at http://www.iasb.org/about/history.asp.

[4] The proceedings of the Congress can be found on the website of the 10th World Congress of Accounting Historians: http://accounting.rutgers.edu/raw/aah/worldcongress/highlights.htm. See also Staub (1938).

[5] The available literature includes Dye (1985), Farrell and Saloner (1985), Dye and Verrecchia (1995) and Pownall and Schipper (1999).

followed constitutes an agreement as to how to implement important financial and legal concepts such as leverage (gearing) and earnings (profit). Accounting methods thus are an integral component of the contracting between firms and other parties, including lenders, shareholders, managers, suppliers and customers.

Failure to specify accounting methods *ex ante* has the potential to create uncertainty in the payoffs to both contracting parties. For example, failure to agree in advance whether unfunded health care commitments to employees are to be counted as debt leaves both the borrower and the lender unsure as to how much debt the borrower can have without violating a leverage covenant. Similarly, failure to specify in advance the rules for counting profits creates uncertainty for investors when they receive a profit report, and raises the cost of capital to the firm. But accounting standards are costly to develop and specify in advance, so they cannot be a complete solution. Economic efficiency implies a trade-off, without a complete set of standards that fully determine financial reporting practice in all future states of the world (i.e., exactly and for all contingencies). Some future states of the world are extremely costly to anticipate and explicitly contract for.[6] Standards thus have their limits.

The alternative to fully specifying *ex ante* the accounting standards to meet every future state of the world requires what I call 'functional completion' (Ball, 1989). Independent institutions then are inserted between the firm and its financial statement users, their function being to decide *ex post* on the accounting standards that would most likely have been specified *ex ante* if the actually realised state had been anticipated and provided for. Prominent examples of independent institutions that play this role in contracting include law courts, arbitrators, actuaries, valuers and auditors. When deciding what would most likely have been specified ex ante if the realised state had been anticipated and provided for, some information is contained in what was anticipated and provided for. This information will include provisions that were specified for similar states to that which occurred. It also will include abstract general provisions that were intended for all states. In financial reporting, this is the issue involved in so-called 'principles-based' accounting: the balance between general and specific provision for future states of the world.

Uniform voluntary standards. I am aware of at least three major advantages of *uniform* (here interpreted as applying equally to all public companies) standards that would cause them to emerge voluntarily (i.e., without state fiat). The first advantage – scale economies – underlies all forms of uniform contracting: uniform rules need only be invented once. They are a type of 'public good', in that the marginal cost of an additional user adopting them is zero. The second advantage of uniform standards is the protection they give auditors against managers playing an 'opinion shopping' game. If all auditors are required to enforce the same rules, managers cannot threaten to shop for an auditor who will give an unqualified opinion on a more favourable rule. The third advantage is eliminating informational externalities arising from lack of comparability. If firms and/or countries use different accounting techniques – even if unambiguously disclosed to all users – they can impose costs on others (in the language of economics, create negative externalities) due to lack of comparability. To the extent that firms internalise these effects, it will be advantageous for them to use the same standards as others.

These advantages imply that some degree of uniformity in accounting standards could be expected to arise in a market (i.e., non-fiat) setting. This is what happened historically: as is the case for most professions, uniform accounting standards initially arose in a market setting, before governments became involved. In the UK, the ICAEW functioned as a largely market-based standard-setter until recently. In the US, the American Association of Public Accountants – the precursor to today's American Institute of Certified Public Accountants – was formed in 1887 as a professional body without state fiat. In 1939, the profession accepted government licensure and bowed to pressure from the SEC to establish a Committee on Accounting Procedure. The CAP issued 51 Accounting Research Bulletins before being replaced in 1959 by the AICPA's Accounting Principles Board (APB), which in turn was replaced in 1973 by the current FASB. While the trend has been to increased regulation (fiat) over time, the origin of uniform accounting standards lies in a voluntary, market setting.[7]

There also are at least three important reasons to expect somewhat less-than-uniform accounting methods to occur in a voluntary setting. First, it is not clear that uniform financial reporting *quality* requires uniform accounting *rules* ('one size fits all'). Uniformity in the eyes of the user could require accounting rules that vary across firms, across locations and across time. Firms differ on myriad dimensions such as strategy, investment policy, financing policy, industry, technology, capital intensity, growth, size, political scrutiny, and geographical location. The types of transactions they enter into differ substantially. Countries differ

[6] In the extreme case of presently unimaginable future states, it is infinitely costly (i.e., impossible, even with infinite resources) to explicitly contract for optimal state-contingent payoffs, including those affected by financial reporting.

[7] Watts and Zimmerman (1986) note the market origins of financial reporting and auditing more generally.

in how they run their capital, labour and product markets, and in the extent and nature of governmental and political involvement in them. It has never been convincingly demonstrated that there exists a unique optimum set of rules for all.

Second, as observed above it is costly to develop a fully detailed set of accounting standards to cover every feasible contingency, so standards are not the only way of solving accounting method choices. Some type of 'functional completion' is required. For example, under 'principles based' accounting, general principles rather than detailed standards are developed in advance and then adapted to specific situations with the approval of independent auditors. It therefore is not optimal for all accounting choices to be made according to uniform standards.

The above-mentioned reasons to expect less than uniform accounting methods in a voluntary setting share the property that uniformity is not the optimal way to go. The third reason, that firms and/or countries using different accounting methods might not fully internalise the total costs imposed on others due to lack of comparability, does not have that property. It therefore provides a rationale for mandating uniformity, to which I now turn.

Mandatory uniform standards are a possible solution to the problem of informational externalities. If their use of different accounting methods imposes costs on others that firms and/or countries do not take into account in their decisions, then it is feasible that the state can improve aggregate welfare by imposing uniformity. Whether the state-imposed solution can be expected to be optimal is another matter. Political factors tend to distort state action, a theme I shall return to.

At a more basic level, it is not clear that imperfect comparability in financial reporting practice is a substantial problem requiring state action. Is accounting information a special economic good? Hotel accommodation, for example, differs enormously in quality. Different hotels and hotel chains differ in the standards they set and the rules they apply. Their rooms are not comparable in size or decor, their elevators do not operate at comparable speed, their staffs are not equally helpful, they have different cancellation policies, etc. There is no direct comparability of one hotel room with another, even with the assistance of the myriad rating systems in the industry, but consumers make choices without the dire consequences frequently alleged to occur from differences in accounting rules. All things considered, the case for imposing accounting uniformity by fiat is far from clear.

2.4. Why is international convergence in accounting standards occurring now?

Accounting is shaped by economics and politics (Watts, 1977; Watts and Zimmerman, 1986), so the source of international convergence in accounting standards is increased cross-border integration of markets and politics (Ball, 1995). Driving this integration is an extraordinary reduction in the cost of international communication and transacting. The cumulative effect of innovations affecting almost all dimensions of information costs – for example in computing, software, satellite and fibre-optic information transmission, the internet, television, transportation, education – is a revolutionary plunge in the cost of being informed about and becoming an actor in the markets and politics of other countries. In my youth, only a small elite possessed substantial amounts of current information about international markets and politics. Today, orders of magnitude more information is freely available to all on the internet. Informed cross-border transacting in product markets and factor markets (including capital and labour markets) has grown rapidly as a consequence. Similarly, voters and politicians are much better informed about the actions of foreign politicians, and their consequences, than just a generation ago. We have witnessed a revolutionary internationalisation of both markets and politics, and inevitably this creates a demand for international convergence in financial reporting.

How far this will go is another matter. Despite the undoubted integration that has occurred, notably in the capital and product markets, most market and political forces are local, and will remain so for the foreseeable future. Consequently, it is unclear how much convergence *in actual financial reporting practice* will (or should) occur. I return to this theme below.

3. Scoring IASB against its stated objectives

This section evaluates the progress the IASB has made toward achieving its stated objectives, which include:[8]

1. 'develop ... high quality, understandable and enforceable global accounting standards ... that require high quality, transparent and comparable information ... to help participants in the world's capital markets and other users ... .'
2. 'promote the use and rigorous application of those standards.'
3. 'bring about convergence ... .'

I discuss progress toward each of these objectives in turn.

3.1. Development

Here the IASB has done extraordinarily well.[9] It

[8] Source: http://www.iasb.org/about/constitution.asp

[9] Deloitte & Touche LLP provide a comprehensive review of IFRS at www.iasplus.com/dttpubs/pubs.htm.

has developed a nearly complete set of standards that, if followed, would require companies to report 'high quality, transparent and comparable information'.

I interpret financial reporting 'quality' in very general terms, as satisfying the demand for financial reporting. That is, high quality financial statements provide useful information to a variety of users, including investors. This requires:

- accurate depiction of economic reality (for example: accurate allowance for bad debts; not ignoring an imperfect hedge);
- low capacity for managerial manipulation;
- timeliness (all economic value added gets recorded eventually; the question is how promptly); and
- asymmetric timeliness (a form of conservatism): timelier incorporation of bad news, relative to good news, in the financial statements.

Accounting standard-setters historically have viewed the determinants of 'quality' as 'relevance' and 'reliability,' but I do not find these concepts particularly useful. For example, IASB and FASB recently have been placing less emphasis on reliability. In my view, this arises from a failure to distinguish reliability that is inherent in the accounting for a particular type of transaction (the extent to which a reported number is subject to unavoidable estimation error) from reliability arising from capacity for managerial manipulation (the extent to which a reported number is subject to self-interested manipulation by management).

Compared to the legalistic, politically and tax-influenced standards that historically have typified Continental Europe, IFRS are designed to:

- reflect economic substance more than legal form;
- reflect economic gains and losses in a more timely fashion (in some respects, even more so than US GAAP);
- make earnings more informative;
- provide more useful balance sheets; and
- curtail the historical Continental European discretion afforded managers to manipulate provisions, create hidden reserves, 'smooth' earnings and hide economic losses from public view.

The only qualification I would make to my favourable assessment of IFRS *qua* standards therefore is the extent to which they are imbued by a 'mark to market' philosophy, an issue to which I return below.

3.2. Promotion

Here the IASB also has experienced remarkable success. Indicators of this success include:

- Almost 100 countries now require or allow IFRS. A complete list, provided by Deloitte and Touche LLP (2006), is provided in Figure 1.
- All listed companies in EU member countries are required to report consolidated financial statements complying with IFRS, effective in 2005.[10]
- Many other countries are replacing their national standards with IFRS for some or all domestic companies.
- Other countries have adopted a policy of reviewing IFRS and then adopting them either verbatim or with minor modification as their national standards.
- The International Organization of Securities Commissions (IOSCO), the international organisation of national securities regulators, has recommended that its members permit foreign issuers to use IFRS for cross-border securities offerings and listings.

The IASB has been tireless in promoting IFRS at a political level, and its efforts have paid off handsomely in terms ranging from endorsement to mandatory adoption. Whether political action translates into actual implementation is another matter, discussed below.

3.3. Convergence

Convergence refers to the process of narrowing differences between IFRS and the accounting standards of countries that retain their own standards. Depending on local political and economic factors, these countries could require financial reporting to comply with their own standards without formally recognising IFRS, they could explicitly prohibit reporting under IFRS, they could permit all companies to report under either IFRS or domestic standards, or they could require domestic companies to comply with domestic standards and permit only cross-listed foreign companies to comply with either. Convergence can offer advantages, whatever the reason for retaining domestic standards. It is a modified version of adoption.

Several countries that have not adopted IFRS at this point have established convergence projects that most likely will lead to their acceptance of IFRS, in one form or another, in the not too distant future. Most notably:

[10] The regulation was adopted on 19 July 2002 by the European Parliament and Council (EC)1606/2002. After extensive political lobbying and debate, the EC 'carved out' two sections of IAS 39, while at the same time announcing this action as exceptional and temporary, and reiterating its support for IFRS.

Figure 1
Use of IFRSs around the world
Use of IFRSs for domestic reporting by listed companies as of February 2006.

Location	IFRSs not permitted	IFRSs permitted	Required for some domestic listed companies	Required for all domestic listed companies
Albania	No stock exchange. Companies use Albanian GAAP.			
Argentina	X			
Armenia				X
Aruba		X		
Austria				X (a)
Australia				X (b)
Bahamas				X
Bahrain			Banks	
Barbados				X
Bangladesh				X
Belgium				X (a)
Belize	No stock exchange. Companies may use IFRSs.			
Benin	X			
Bermuda		X		
Bolivia		X		
Botswana		X		
Brazil	X			
Brunei Darussalam		X		
Bulgaria				X
Burkina Faso	X			
Cambodia	No stock exchange. Companies may use IFRSs.			
Cayman Islands		X		
Canada	X			
Chile	X			
China			X	
Cote D'Ivoire	X			
Colombia	X			
Costa Rica				X
Croatia				X
Cyprus				X (a)
Czech Rep.				X (a)
Denmark				X (a)
Dominica		X		
Dominican Rep.				X
Ecuador				X
Egypt				X
El Salvador		X		
Estonia				X (a)
Finland				X (a)
Fiji	X			
France				X (a)
Germany				X (a)
Georgia				X
Ghana	X			
Gibraltar		X		
Greece				X (a)
Guam	No stock exchange. Companies use US GAAP.			
Guatemala				X
Guyana				X
Haiti				X
Honduras				X
Hong Kong				X (c)
Hungary				X (a)
Iceland				X (a)
India	X			
Indonesia	X			
Ireland				X (a)
Israel	X			
Italy				X (a)
Jamaica				X
Japan	X			
Jordan				X
Kazakhstan			Banks	
Kenya				X
Korea (South)	X			
Kuwait				X
Kyrgyzstan				X
Laos		X		
Latvia				X (a)
Lebanon				X
Liechtenstein				X (a)
Lesotho		X		
Lithuania				X (a)
Luxembourg				X (a)
Macedonia				X
Malawi				X
Mali	X			
Malta				X (a)
Malaysia	X			
Mauritius				X
Mexico	X			
Moldova	X			
Myanmar		X		
Namibia		X		
Netherlands				X (a)
NL Antilles		X		
Nepal				X
New Zealand				2007 (b)
Niger	X			
Norway				X (a)
Oman				X
Pakistan	X			
Panama				X
Papua New Guinea				X
Peru				X
Philippines				X (c)
Poland				X (a)
Portugal				X (a)
Romania			All large companies	
Russian Federation			X	Proposed phase-in starting 2006
Saudi Arabia	X			
Singapore				X (c)
Slovenia				X (a)
Slovak Rep.				X (a)
South Africa				X
Spain				X
Sri Lanka		X		
Sweden				X (a)
Syria	X			
Swaziland		X		
Switzerland		X		
Taiwan	X			
Tajikistan				X
Tanzania				X
Thailand	X			
Togo	X			
Trinidad and Tobago				X
Tunisia	X			
Turkey		X		
Uganda		X		
Ukraine				X
United Arab Emirates			Banks and some others	
United Kingdom				X (a)
United States	X			
Uruguay	X (d)			
Uzbekistan	X			
Venezuela				X
Vietnam	X			
Yugoslavia				X
Zambia		X		
Zimbabwe		X		

(a) Audit report refers to IFRSs as adopted by the EU.
(b) Compliance with IFRSs is stated in a note.
(c) IFRSs adopted virtually in full as national GAAP.
(d) By law, all companies must follow IFRSs existing at 19 May 2004. The auditor's report refers to conformity with Uruguayan GAAP.

Source: Deloitte, Touche, Tohmatsu, *IFRS in Your Pocket 2006*, fifth edition, April, at: http://www.iasplus.com/dttpubs/pocket2006.pdf.

- Since October 2002, the IASB and the FASB have been working systematically toward convergence of IFRS and US GAAP. The Securities and Exchange Commission (SEC), the US national market regulator, has set a target date no later than 2009 for it accepting financial statements of foreign registrants that comply with IFRS.
- The IASB recently commenced a similar, though seemingly less urgent and ambitious, convergence project with Japan.

I repeat the caveat that converge *de facto* is less certain than convergence *de jure*: convergence in actual financial reporting practice is a different thing than convergence in financial reporting standards. I return to this point in Section 6 below.

4. Advantages of IFRS for investors

4.1. Direct IFRS advantages for investors

Widespread international adoption of IFRS offers equity investors a variety of potential advantages. These include:

1. IFRS promise more accurate, comprehensive and timely financial statement information, relative to the national standards they replace for public financial reporting in most of the countries adopting them, Continental Europe included. To the extent that financial statement information is not known from other sources, this should lead to more-informed valuation in the equity markets, and hence lower risk to investors.
2. Small investors are less likely than investment professionals to be able to anticipate financial statement information from other sources. Improving financial reporting quality allows them to compete better with professionals, and hence reduces the risk they are trading with a better-informed professional (known as 'adverse selection').[11]
3. By eliminating many international differences in accounting standards, and standardising reporting formats, IFRS eliminate many of the adjustments analysts historically have made in order to make companies' financials more comparable internationally. IFRS adoption therefore could reduce the cost to investors of processing financial information. The gain would be greatest for institutions that create large, standardised-format financial databases.
4. A bonus is that reducing the cost of processing financial information most likely increases the efficiency with which the stock market incorporates it in prices. Most investors can be expected to gain from increased market efficiency.
5. Reducing international differences in accounting standards assists to some degree in removing barriers to cross-border acquisitions and divestitures, which in theory will reward investors with increased takeover premiums.[12]

In general, IFRS offer increased comparability and hence reduced information costs and information risk to investors (provided the standards are implemented consistently, a point I return to below).

4.2. Indirect IFRS advantages for investors

IFRS offer several additional, indirect advantages to investors. Because higher information quality should reduce both the risk to all investors from owning shares (see 1. above) and the risk to less-informed investors due to adverse selection (see 2. above), in theory it should lead to a reduction in firms' costs of equity capital.[13] This would increase share prices, and would make new investments by firms more attractive, other things equal.

Indirect advantages to investors arise from improving the usefulness of financial statement information in contracting between firms and a variety of parties, notably lenders and managers (Watts, 1977; Watts and Zimmerman, 1986). Increased transparency causes managers to act more in the interests of shareholders. In particular, timelier loss recognition in the financial statements increases the incentives of managers to attend to existing loss-making investments and strategies more quickly, and to undertake fewer new investments with negative NPVs, such as 'pet' projects and 'trophy' acquisitions (Ball 2001; Ball and Shivakumar, 2005). Ball (2004) concludes this was the primary motive behind the 1993 decision of Daimler-Benz (now DaimlerChrysler) AG to list on the New York Stock Exchange and report financial statements complying with US GAAP: due to intensifying product market competition and hence lower profit margins in its core automobile businesses, Daimler no longer could afford to subsidise loss-making activities. Bushman et al. (2006) report evidence that firms in countries with timelier financial-statement recognition of losses

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[11] See Glosten and Milgrom (1985), Diamond and Verrecchia (1991) and Leuz and Verrecchia (2000).

[12] See Bradley, Desai and Kim (1988).

[13] The magnitude of cost of capital benefits from disclosure is an unsettled research question, both theoretically and empirically. Empirical studies encounter the problem of controlling for correlated omitted variables, notably companies' growth opportunities. Theory research is sensitive to model assumptions, and frequently can offer insights into the direction but not the magnitude of any effects. See Diamond and Verrecchia (1991), Botosan (1997), Leuz and Verrecchia (2000), Botosan and Plumlee (2002), Hail (2002), Daske (2006) and Easton (2006).

are less likely to undertake negative-NPV investments. The increased transparency and loss recognition timeliness promised by IFRS therefore could increase the efficiency of contracting between firms and their managers, reduce agency costs between managers and shareholders, and enhance corporate governance.[14] The potential gain to investors arises from managers acting more in their (i.e., investors') interests.

The increased transparency promised by IFRS also could cause a similar increase in the efficiency of contracting between firms and lenders. In particular, timelier loss recognition in the financial statements triggers debt covenants violations more quickly after firms experience economic losses that decrease the value of outstanding debt (Ball 2001, 2004; Ball and Shivakumar 2005; Ball et al., 2006). Timelier loss recognition involves timelier revision of the book values of assets and liabilities, as well as earnings and stockholders' equity, causing timelier triggering of covenants based on financial statement variables. In other words, the increased transparency and loss recognition timeliness promised by IFRS could increase the efficiency of contracting in debt markets, with potential gains to equity investors in terms of reduced cost of debt capital.

An ambiguous area for investors will be the effect of IFRS on their ability to forecast earnings. One school of thought is that better accounting standards make reported earnings less noisy and more accurate, hence more 'value relevant'. Other things equal (for example, ignoring enforcement and implementation issues for the moment) this would make earnings easier to forecast and would improve average analyst forecast accuracy.[15] The other school of thought reaches precisely the opposite conclusion. This reasoning is along the lines that managers in low-quality reporting regimes are able to 'smooth' reported earnings to meet a variety of objectives, such as reducing the volatility of their own compensation, reducing the volatility of payouts to other stakeholders (notably, employee bonuses and dividends), reducing corporate taxes, and avoiding recognition of losses.[16] In contrast, earnings in high-quality regimes are more informative, more volatile, and more difficult to predict. This argument is bolstered in the case of IFRS by their emphasis on 'fair value accounting', as outlined in the following section. Fair value accounting rules aim to incorporate more-timely information about economic gains and losses on securities, derivatives and other transactions into the financial statements, and to incorporate more-timely information about contemporary economic losses ('impairments') on long term tangible and intangible assets. IFRS promise to make earnings more informative and therefore, paradoxically, more volatile and more difficult to forecast.

In sum, there are a variety of indirect ways in which IFRS offer benefits to investors. Over the long term, the indirect advantages of IFRS to investors could well exceed the direct advantages.

5. Fair value accounting

A major feature of IFRS qua standards is the extent to which they are imbued with fair value accounting [a.k.a. 'mark to market' accounting]. Notably:

- IAS 16 provides a fair value option for property, plant and equipment;
- IAS 36 requires asset impairments (and impairment reversals) to fair value;
- IAS 38 requires intangible asset impairments to fair value;
- IAS 38 provides for intangibles to be revalued to market price, if available;
- IAS 39 requires fair value for financial instruments other than loans and receivables that are not held for trading, securities held to maturity; and qualifying hedges (which must be near-perfect to qualify);[17]
- IAS 40 provides a fair value option for investment property;
- IFRS 2 requires share-based payments (stock, options, etc.) to be accounted at fair value; and
- IFRS 3 provides for minority interest to be recorded at fair value.

This list most likely will be expanded over time. Both IASB and FASB have signalled their intent to do so.

I have distinctly mixed views on fair value accounting. The fundamental case in favour of fair value accounting seems obvious to most economists: fair value incorporates more information into the financial statements. Fair values contain more information than historical costs whenever there exist either:

1. Observable market prices that managers cannot materially influence due to less than perfect market liquidity; or

[14] These 'numerator' effects of higher quality financial reporting (i.e., increasing the cash flows arising from managers' actions) in my view are likely to have a considerably larger influence on firms' values than any 'denominator' effects (i.e., reducing the cost of capital). See Ball (2001: 140–141). However, it is difficult to disentangle the two effects in practice.

[15] See Ashbaugh and Pincus (2001), Hope (2003) and Lang, Lins and Miller (2003).

[16] See Ball, Kothari and Robin (2000) and Ball, Robin and Wu (2003).

[17] Available-for-sale securities are to be shown at Fair Value in the Balance Sheet only.

2. Independently observable, accurate estimates of liquid market prices.

Incorporating more information in the financial statements by definition makes them more informative, with potential advantages to investors, and other things equal it makes them more useful for purposes of contracting with lenders, managers and other parties.[18]

Over recent decades, the markets for many commodities and financial instruments, including derivatives, have become substantially deeper and more liquid. Some of these markets did not even exist 30 years ago. There has been enormous concurrent growth in electronic databases containing transactions prices for commodities and securities, and for a variety of assets such as real estate for which comparable sales can be used in estimating fair values. In addition, a variety of methods for reliably estimating fair values for untraded assets have become generally acceptable. These include the present value (discounted cash flow) method, the first application of which in formal accounting standards was in lease accounting (SFAS No. 13 in 1976), and a variety of valuation methods adapted from the original Black-Scholes (1973) model. In view of these developments, it stands to reason that accountants have been replacing more and more historical costs with fair values, obtained both from liquid market prices and from model-based estimates thereof.

The question is whether IASB has pushed (and intends to push) fair value accounting too far. There are many potential problems with fair value in practice, including:[19]

- Market liquidity is a potentially important issue in practice. Spreads can be large enough to cause substantial uncertainty about fair value and hence introduce noise in the financial statements.
- In illiquid markets, trading by managers can influence traded as well as quoted prices, and hence allows them to manipulate fair value estimates.
- Worse, companies tend to have positively correlated positions in commodities and financial instruments, and cannot all cash out simultaneously at the bid price, let alone at the ask. Fair value accounting has not yet been tested by a major financial crisis, when lenders in particular could discover that 'fair value' means 'fair weather value'.
- When liquid market prices are not available, fair value accounting becomes 'mark to model' accounting. That is, firms report estimates of market prices, not actual arm's length market prices. This introduces 'model noise,' due to imperfect pricing models and imperfect estimates of model parameters.
- If liquid market prices are available, fair value accounting reduces opportunities for self-interested managers to influence the financial statements by exercising their discretion over realising gains and losses through the timing of asset sales. However, fair value accounting increases opportunities for manipulation when 'mark to model' accounting is employed to simulate market prices, because managers can influence both the choice of models and the parameter estimates.

It is important to stress that volatility per se is not the concern here. Volatility is an advantage in financial reporting, whenever it reflects timely incorporation of new information in earnings, and hence onto balance sheets (in contrast with 'smoothing,' which reduces volatility). However, volatility becomes a disadvantage to investors and other users whenever it reflects estimation noise or, worse, managerial manipulation.

The fair value accounting rules in IFRS place considerable faith in the 'conceptual framework' that IASB and FASB are jointly developing (IASB, 2001). This framework:

- is imbued with a highly controversial 'value relevance' philosophy;
- emphasises 'relevance' relative to 'reliability;'
- assumes the sole purpose of financial reporting is direct 'decision usefulness;'
- downplays the indirect 'stewardship' role of accounting; and
- could yet cause IASB and FASB some grief.

IASB and FASB seem determined to push ahead with it nevertheless. FASB staff member L. Todd Johnson (2005) concludes:

'The Board has required greater use of fair value measurements in financial statements because it perceives that information as more relevant to investors and creditors than historical cost information. Such measures better reflect the present financial state of reporting entities and better facilitate assessing their past performance and future

[18] Ball, Robin and Sadka (2006) conclude from a cross-country analysis that providing new information to equity investors is not the dominant economic function of financial reporting (investors can be informed about gains and losses in a timely fashion via disclosure, without financial statement recognition). Conversely, the dominant function of timely loss recognition is to facilitate contracting (the study focused on debt markets).

[19] In addition, gains and losses in fair value are transitory in nature and hence are unlike recurring business income. For example, they normally will sell at lower valuation multiples. To avoid misleading investors, fair value gains and losses need to be clearly labelled as such.

prospects. In that regard, the Board does not accept the view that reliability should outweigh relevance for financial statement measures.'

Noisy information on gains and losses is more informative than none, so even the least reliable 'mark to model' estimates certainly incorporate more information. But this is not a sufficient basis for justifying fair value accounting, for at least four reasons:

1. 'Value relevance' (i.e., informing users) is by no means the sole criterion for financial reporting. One also has to consider the role of financial reporting in contexts where noise matters, including debt and compensation contracts (Watts and Zimmerman, 1986; Holthausen and Watts, 2001). Noise in any financial information that affects contractual outcomes (e.g., lenders' rights when leverage ratio or interest coverage covenants are violated; managers' bonuses based on reported earnings) increases the risk faced by *both* the firm and contracting parties. Other things equal, it thus is a source of contracting inefficiency. Providing more information thus can be worse than providing less, if it is accompanied by more noise. 'Mark to model' fair value accounting can add volatility to the financial statements in the form of both information (a 'good') and noise arising from inherent estimation error and managerial manipulation (a 'bad').

2. It is important to distinguish 'recognition' (incorporating information in the audited financial statements, notably by including estimated gains and losses in earnings and book value) from 'disclosure' (informing investors, for example by audited footnote disclosure or provision of unaudited information, without incorporation in earnings or on balance sheets). Noisy fair value information does not necessarily have to be recognised to be useful to equity investors.[20] The case for increased deployment of fair value accounting in the audited financial statements is not based on any substantial body of evidence – at least of which I am aware – that gain and loss information is not available from sources outside the financial statements, and that value is added in the economy by auditing it, let alone by incorporating it in earnings.

3. Financial reporting conveys an important economic role by accurately and independently counting actual outcomes, and hence confirming prior information about expected outcomes. In particular, if managers believe actual outcomes are more likely to be reported accurately and independently, they are less likely to disclose misleading information about their expectations. It is possible that, as a financial reporting regime strays far from reporting outcomes by incorporating more information about expectations, the reliability of the available information about expectations begins to fall. A feasible outcome is that the amount of information contained in the financial statements rises, and at the same time the total amount of information falls.[21]

4. Accounting standards and – what is more important – accounting practice have long since been imbued with one of the two sides of 'fair value' accounting. That is, timely loss recognition, in which expected future cash losses are charged against current earnings and book value of equity, is a long-standing property of financial reporting. The other side of 'fair value,' timely gain recognition, is not as prevalent in practice (Basu, 1997). Loss recognition timeliness is particularly evident in common-law countries such as Australia, Canada, UK and US (Ball et al., 2000). It affects financial reporting practice in many ways, including the pervasive 'lower of cost or market' rule (for example, accruing expected decreases in the future realisable value of inventory against current earnings, but not expected increases), accruing loss contingency provisions (but setting a higher standard for verification of gain contingencies), and long term asset impairment charges (but not upward revaluations). It simply is incorrect to view the prevailing financial reporting model as 'historical cost accounting'. Financial reporting, particularly in common-law countries, is a mixed process involving both historical costs and (especially contingent on losses) fair values.

In sum, I have mixed views about the extent to which IFRS are becoming imbued with the current IASB/FASB fascination with 'fair value accounting'. On the one hand, this philosophy promises to incorporate more information in the financial statements than hitherto. On the other, it does not necessarily make investors better off and its usefulness in other contexts has not been clearly demonstrated. Worse, it could make investors and other users worse off, for a variety of reasons. The jury is still out on this issue.

[20] Barth, Clinch and Shibano (2003) provide some theoretical support for the proposition that recognition matters per se, though the result flows directly from the model's assumptions. Ball, Robin and Sadka (2006) argue that equity investors are relatively indifferent between receiving a given amount of information (i.e., controlling for the amount of noise) via disclosure and via recognition in the financial statements. Conversely, they argue that the demand for recognition versus disclosure arises primarily from the use of financial statements in debt markets.

[21] See Ball (2001: 133–138) for elaboration.

6. Effect on investors of uneven implementation

I believe there are overwhelming political and economic reasons to expect IFRS enforcement to be uneven around the world, including within Europe. Substantial international differences in financial reporting practice and financial reporting quality are inevitable, international standards or no international standards. This conclusion is based on the premise that – despite increased globalisation – most political and economic influences on financial reporting *practice* remain local. It is reinforced by a brief review of the comparatively toothless body of international enforcement agencies currently in place. The conclusion also is supported by a fledgling academic literature on the relative roles of accounting standards and the incentives of financial-statement preparers in determining actual financial reporting practice.

One concern that arises from widespread IFRS adoption is that investors will be mislead into believing that there is more uniformity in practice than actually is the case and that, even to sophisticated investors, international differences in reporting quality now will be hidden under the rug of seemingly uniform standards. In addition, uneven implementation curtails the ability of uniform standards to reduce information costs and information risk, described above as an advantage to investors of IFRS. Uneven implementation could increase information processing costs to transnational investors – by burying accounting inconsistencies at a deeper and less transparent level than differences in standards. In my view, IFRS implementation has not received sufficient attention, perhaps because it lies away from public sight, 'under the rug'.

6.1. Markets and politics remain primarily local, not global

The fundamental reason for being sceptical about uniformity of implementation in practice is that the incentives of preparers (managers) and enforcers (auditors, courts, regulators, boards, block shareholders, politicians, analysts, rating agencies, the press) remain primarily local.

All accounting accruals (versus simply counting cash) involve judgments about future cash flows. Consequently, there is much leeway in implementing accounting rules. Powerful local economic and political forces therefore determine how managers, auditors, courts regulators and other parties influence the implementation of rules. These forces have exerted a substantial influence on financial reporting practice historically, and are unlikely to suddenly cease doing so, IFRS or no IFRS. Achieving uniformity in accounting standards seems easy in comparison with achieving uniformity in actual reporting behaviour. The latter would require radical change in the underlying economic and political forces that determine actual behaviour.

Sir David Tweedie, IASB chairman, premises the case for international uniformity in accounting standards on global integration of markets:[22]

'As the world's capital markets integrate, the logic of a single set of accounting standards is evident. A single set of international standards will enhance comparability of financial information and should make the allocation of capital across borders more efficient. The development and acceptance of international standards should also reduce compliance costs for corporations and improve consistency in audit quality.'

But this logic works both ways. One can change the underlying premise to make a case *against* uniformity. Because capital markets are not perfectly integrated (debt markets in particular), and because more generally economic and political integration are both far from being complete, the logic of national *differences* should be equally evident. While increased internationalisation of markets and politics can be expected to reduce some of the diversity in accounting practice across nations, nations continue to display clear and substantial domestic facets in both their politics and how their markets are structured, so increased internationalisation cannot be expected to eliminate diversity in practice.

I have heard an analogy made between IFRS and the metric system of uniform weights and measures.[23] The analogy is far from exact, but instructive nevertheless. There is an old saying: 'The weight of the butcher's thumb on the scale is heavier in ... [other country X].' Despite uniform measurement rules, the butcher's discretion in implementing them is limited only by the practised eye of the customer, by concern for reputation, and by the monitoring of state and private inspection systems. The lesson from this saying is that monitoring mechanisms operate differently across nations. There is considerably more discretion in implementing financial reporting rules than in

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[22] Considering the amount of time the IASB has exerted in lobbying governments (the EU included) on IFRS adoption, there is some irony in Sir David focusing on international integration of markets, without mentioning integration of political forces. The strongly adverse initial reaction to the publication of Watts (1977) and Watts and Zimmerman (1978), introducing the topic of political influences on financial reporting practice, suggests this is a sensitive issue.

[23] The metric system was first proposed in 1791, was adopted by the French revolutionary assembly in 1795, and was substantially refined and widely adopted during the second half of the nineteenth century (primarily in code law countries). France then ceded control of the system to an international body, and in 1875 the leading industrialised countries (including the US, but not the UK) created the International Bureau of Weights and Measures to administer it.

weighing meat, and consequently this is offset by considerably more complex, frequent and effective financial reporting monitoring mechanisms. But here too the monitoring mechanisms operate differently across nations.

Before getting too carried away with globalisation, it is worth remembering that in fact most markets and most politics are local, not global. The late Tip O'Neill, long-time speaker of the US House of Representatives, famously stated (O'Neill, 1993): 'All politics is local.' Much the same could be said about markets. Important dimensions in which the world still looks considerably more local than global include:

- Extent and nature of government involvement in the economy;
- Politics of government involvement in financial reporting practices (e.g., political influence of managers, corporations, labour unions, banks);
- Legal systems (e.g., common versus code law; shareholder litigation rules);
- Securities regulation and regulatory bodies;
- Depth of financial markets;
- Financial market structure (e.g., closeness of relationship between banks and client companies);
- The roles of the press, financial analysts and rating agencies;
- Size of the corporate sector;
- Structure of corporate governance (e.g., relative roles of labour, management and capital);
- Extent of private versus public ownership of corporations;
- Extent of family-controlled businesses;
- Extent of corporate membership in related-company groups (e.g., Japanese *keiretsu* or Korean *chaebol*);
- Extent of financial intermediation;
- The role of small shareholders vs. institutions and corporate insiders;
- The use of financial statement information, including earnings, in management compensation; and
- The status, independence, training and compensation of auditors.

The above list is far from complete, but it gives some sense of the extent to which financial reporting occurs in a local, not global, context. Despite increased globalisation, the clear majority of economic and political activity remains *intra*national, the implication being that the primary driving forces behind the majority of actual accounting practices seem likely to remain domestic in nature for the foreseeable future.

The most visible effect of local political and economic factors on IFRS lies at the level of the national standard adoption decision.[24] This already has occurred to a minor degree, in the EU 'carve out' from IAS 39 in the application of fair value accounting to interest rate hedges. The European version of IAS 39 emerged in response to considerable political pressure from the government of France, which responded to pressure from domestic banks concerned about balance sheet volatility.[25] Episodes like this are bound to occur in the future, whenever reports prepared under IFRS produce outcomes that adversely affect local interests.

Another level at which local political and economic factors are likely to visibly influence IFRS adoption stems from the latitude IFRS give to firms to choose among alternative accounting methods.[26] Local factors make it unlikely that this discretion will be exercised uniformly across countries, and across firms within countries.

Nevertheless, in my view the most likely effect of local politics and local market realities on IFRS will be much less visible than was the case with the prolonged political debate on IAS 39. I believe the primary effect of local political and market factors will lie under the surface, at the level of implementation, which is bound to be substantially inconsistent across nations.

Does anyone seriously believe that implementation will be of equal standard in all the nearly 100 countries, listed in Figure 1, that have announced adoption of IFRS in one way or another? The list of adopters ranges from countries with developed accounting and auditing professions and developed capital markets (such as Australia) to countries without a similarly developed institutional background (such as Armenia, Costa Rica, Ecuador, Egypt, Kenya, Kuwait, Nepal, Tobago and Ukraine).

Even within the EU, will implementation of IFRS be at an equal standard in all countries? The list includes Austria, Belgium, Cyprus, Czech Republic, Denmark, Germany, Estonia, Greece, Spain, France, Ireland, Italy, Latvia, Lithuania, Luxembourg, Hungary, Malta, Netherlands, Poland, Portugal, Slovenia, Slovakia, Finland, Sweden and

[24] Zeff (2006) surveys political influences on standard adoptions in the US, Canada, the UK and Sweden, and also in relation to IFRS.

[25] In my view, governments will not in practice cede the decision to impair banks' balance sheets to accountants. In the event of a financial crisis, there is strong political pressure to not mark banks' balance sheets to market, in order to avoid bank closures resulting from violating prudential ratios, as witnessed in Japan over the last decade.

[26] See Watts (1977) and Watts and Zimmerman (1986).

the UK. It is well known that uniform EU economic rules in general are not implemented evenly, with some countries being notorious standouts.[27] What makes financial reporting rules different?

Accounting accruals generally require at least some element of subjective judgment and hence can be influenced by the incentives of managers and auditors. Consider the case of IAS 36 and IAS 38, which require periodic review of long term tangible and intangible assets for possible impairment to fair value. Do we seriously believe that managers and auditors will comb through firms' asset portfolios to discover economically impaired assets with the same degree of diligence and ruthlessness in all the countries that adopt IFRS? Will auditors, regulators, courts, boards, analysts, rating agencies, the press and other monitors of corporate financial reporting provide the same degree of oversight in all IFRS-adopting countries? In the event of a severe economic downturn creating widespread economic impairment of companies' assets, will the political and regulatory sectors of all countries be equally likely to turn a blind eye? Will they be equally sympathetic to companies failing to record economic impairment on their accounting balance sheets, in order to avoid loan default or bankruptcy (as did Japanese banks for an extended period)? Will local political and economic factors cease to exert the influence *on actual financial reporting practice* that they have in the past? Or will convergence among nations in adopted accounting standards lead to an offsetting divergence in the extent to which they are implemented?

The drift toward fair value accounting in IFRS will only accentuate the extent to which IFRS implementation depends on manager and auditor judgment, and hence is subject to local political and economic influence. Furthermore, the clear majority of IFRS adopting countries cannot be said to possess deep securities, derivatives and currency markets. Implementation of the IFRS fair value accounting standards in many countries will encounter problems with illiquidity, wide spreads and subjectivity in 'mark to model' estimates of fair value. Furthermore, in many countries the available information needed to implement the asset impairment standards is meagre and not readily observable to auditors and other monitors. To make matters worse, the countries in which there will be greater room to exercise judgment under fair value accounting, due to lower-liquidity markets and poorer information about asset impairment, are precisely the countries with weaker local enforcement institutions (audit profession, legal protection, regulation, and so on). Judgment is a generic property of accounting standard implementation, but worldwide reliance on judgment has been widely expanded under IFRS by the drift to fair value accounting and by the adoption of fair value standards in countries with illiquid markets.

It is worth bearing in mind that from the outset the IASC, the precursor to the IASB, has been strongly supported by the 'G4+1' common law countries (Australia, Canada, New Zealand, UK and US) which have comparatively deep markets and comparatively developed shareholders' rights, auditing professions, and other monitoring systems. Its philosophy has been tilted toward a common-law view of financial reporting (a topic discussed further below). This view forms the foundation for accounting standards that require timely recognition of losses, in particular the asset impairment standards IAS 36 and IAS 38. Historically, common-law financial reporting has exhibited a substantially greater propensity to recognise economic losses in a timely fashion than financial reporting in Continental Europe and Asia (Ball, Kothari and Robin, 2000; Ball et al., 2003). Implementation of IAS 36 and IAS 38 requires subjective assessments of future cash flows, sometimes decades into the future, and thus is subject to a large degree of discretion. It remains to be seen if managers, auditors, regulators and other monitors outside of the common-law countries will be persuaded by IFRS adoption that it is in their interests to radically change their behaviour.

In sum, even a cursory review of the political and economic diversity among IFRS-adopting nations, and of their past and present financial reporting practices, makes the notion that uniform standards alone will produce uniform financial reporting seems naive. This conclusion is strengthened by the following review of the weak international IFRS enforcement mechanisms that are in place, and by a review of the relevant literature on the relative roles of accounting standards and the reporting incentives of financial statement preparers (i.e., managers and auditors).

6.2. IFRS enforcement mechanisms

Under its constitution, the IASB is a standard-setter and does not have an enforcement mechanism for its standards: it can cajole countries and companies to adopt IFRS in name, but it cannot require their enforcement in practice. It cannot penalise individual companies or countries that adopt its standards, but in which financial reporting practice is of low quality because managers, auditors and local regulators fail to fully implement the standards. Nor has it shown any interest in disal-

[27] For example, the *Financial Times* (July 19, 2005) reports that 'Italy has the worst record of all European Union member states when it comes to implementing the laws that underpin the EU's internal market, according to data released by the European Commission yesterday. ... The worst performers apart from Italy are Luxembourg, Greece, the Czech Republic and Portugal.'

lowing or even dissuading low-quality companies or countries from using its 'brand name'. Individual countries remain primarily regulators of their own financial markets, EU member countries included. That exposes IFRS to the risk of adoption in name only.

Worldwide regulatory bodies generally are regarded as toothless watchdogs, despite recent attempts to strengthen them. The 'alphabet soup' of international regulators now includes:

- International Auditing and Assurance Standards Board (IAASB), a committee of the International Federation of Accountants (IFAC). IAASB issues and promotes uniform auditing practices worldwide, but lacks effective enforcement powers.
- International Organization of Securities Commissions (IOSCO), an umbrella organisation of national regulators. IOSCO develops and promotes securities regulation standards and their enforcement. It encourages member countries to adopt IFRS, but does not police their enforcement.
- Public Interest Oversight Board (PIOB), established in February 2005 by IOSCO, the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the World Bank, and the Financial Stability Forum. PIOB will oversee IFAC's standard-setting activities in audit performance, independence, ethics, quality control, assurance and education. In relation to enforcement, it will oversee IFAC's Member Body Compliance Program.

European regulatory bodies include:

- Committee of European Securities Regulators (CESR). CESR promulgates high-level IFRS enforcement principles.
- EU Directive on Statutory Audit of Annual Accounts and Consolidated Accounts. The EU Directive mandates EU-wide auditing standards.

Whether these bodies will substantially harmonise actual reporting behaviour in not yet clear. Even if all IFRS-adopting nations agreed to fully cede their sovereignty over regulation of financial reporting to these transnational bodies, which seems highly doubtful, domestic political and economic forces most likely would cause them to abrogate that agreement whenever it suited them.[28]

6.3. *Standards versus incentives*

An emerging literature investigates the extent to which differences in actual reporting behaviour are endogenous (i.e., determined by real economic and political factors that are local in nature and that differ among countries). The relevance of this literature to IFRS implemenation is the implication that, to the extent financial reporting practice is endogenous, an exogenously-developed set of accounting standards is unlikely to materially change firms' actual reporting behaviour. Complete endogeneity would imply that change in financial reporting would occur only if there was change in the real economic and political factors that determine it – for example, it would imply that uniform financial reporting would only occur under perfectly integrated world markets and political systems, uniform standards notwithstanding. Partial endogeneity would imply that adopting uniform international standards would have some, but limited, success in overcoming national differences in the real economic and political factors that determine actual practice, and hence in reducing differences in financial reporting practice.

Research on the economic and political factors that influence financial reporting practice internationally includes Ball, Kothari and Robin (2000); Pope and Walker (1999); Ball, Robin and Wu (2000, 2003); Ali and Hwang (2000); Leuz (2003); Leuz, Nanda and Wysocki (2003); Bushman, Piotroski and Smith (2004, 2006); Bushman and Piotroski (2006); Ball, Robin and Sadka (2006); and Leuz and Oberholzer (2006). One contribution of this research is to document substantial differences among countries in reporting behavior that are endogenously determined by local economic and political factors. This evidence implies that adopting uniform IFRS would not fully overcome national differences in financial reporting practice. A related contribution is more direct evidence that exogenously imposed standards do not substantially influence financial reporting quality.

Ball, Kothari and Robin (2000) investigate differences in financial reporting quality between common-law and code-law countries.[29] Common law takes its name from the process whereby laws originate: it its pure form, common law arises from what is commonly accepted to be appropriate practice. Common law originated in England and spread to its former colonies (US, Canada,

[28] A recent parallel is France's refusal to enforce EU takeover rules, which has led to considerable watering down of the rules after a decade of negotiation. In the meantime, France announced it would block rumoured takeovers of Groupe Danone SA by the US company PepsiCo Inc., and of Suez SA by Italy's Enel SpA. As a result of France's political position, EU rules have been loosened so that member states now have wide latitude to set their own standards in relation to takeover defences. The notion of an integrated European market for corporate control thereby has been considerably diluted. The lesson is that global rules will prevail so long as they do not run foul of important local interests. Why would financial reporting rules be any different?

[29] Ball, Kothari and Robin (2000) was replicated and extended (the publication dates are misleading) by Pope and Walker (1999).

Australia, New Zealand). It tends to be more market-oriented, supports a proportionately larger listed corporate sector, is more litigious, tends to presume that investors are outsiders 'at arm's-length' from the company, and hence is more likely to presume that investors rely on timely public disclosure and financial reporting. Financial reporting practice (and rules) emphasises timely recognition of losses in the financial statements. Earnings are more volatile, more informative, and more closely-followed by investors and analysts. Unlike code law, common law in its purest form makes standard-setting a private-sector responsibility.

Code law also takes its name from the process whereby laws, including financial reporting rules, are created: they are 'coded' in the public sector. Politically powerful stakeholder groups necessarily are represented in both codifying and implementing rules. Code law originated in Continental Europe and spread to the former colonies of Belgium, France, Germany, Italy, Portugal and Spain. Code-law countries generally are less market-oriented, have proportionately larger government and unlisted private-company sectors, are less litigious, and are more likely to operate an 'insider access' model with less emphasis on public financial reporting and disclosure. There is less emphasis on timely recognition of losses in the public financial statements, and earnings have lower volatility and lower informativeness.

Ball, Robin and Wu (2003) study four East Asian countries. They argue that the companies in these countries are more likely to be members of related corporate groups, including those under family control, in which a version of the 'insider access' model operates and hence there is less emphasis than under common law on public financial reporting and disclosure. While the specific politically powerful stakeholder groups are different than in typical code-law countries (notably, organised labour typically has less political clout in Asia than in code law countries), governments play a similar role in the economy.

In practice, the distinction between the code-law, common-law and Asian groupings is blurred (for example, where does one place Hong Kong over time?). Ball, Kothari and Robin (2000) and Ball, Robin and Wu (2003) use the categories as an imperfect proxy for the extent and type of political involvement in the economy, and hence of the extent to which political (versus market) factors influence finacial reporting practice. Countries with highly politicised economies are more likely to politicise financial reporting practice, but they also tend to gravitate toward an 'insider access' (versus public disclosure) model and to grant politically powerful stakeholder groups an important role. Leuz, Nanda and Wysocki (2003) eschew country-type classifications and employ the more-detailed legal-system variables reported in La Porta et al. (1997, 1998), though in a different context Ball, Robin and Sadka (2006) report evidence that country-type variables work better, consistent with the view that detailed institutional variables are endogenously determined by more primitive political and economic factors. Which approach better explains international differences in financial reporting practice is an interesting and not fully resolved issue. Nevertheless, all studies indicate that differences in actual reporting behavior are endogenous (i.e., determined by real economic and political factors that differ among countries).

Some idea of international differences in financial reporting quality can be obtained from Figure 2, which summarises results in Ball, Kothari and Robin (2000) and Ball, Robin and Wu (2000, 2003). The three panels graph the sensitivity of reported earnings to contemporary economic gains and losses, as measured imperfectly by fiscal-year stock returns (details are provided in the source articles). The heights of the bars represent estimates of the sensitivity of earnings to contemporary economic gains (black bars) and to contemporary economic losses (white bars) in a particular country or group of countries. These sensitivity estimates capture the timeliness of gain and loss recognition in the countries and country groups – important attributes of financial reporting quality.[30]

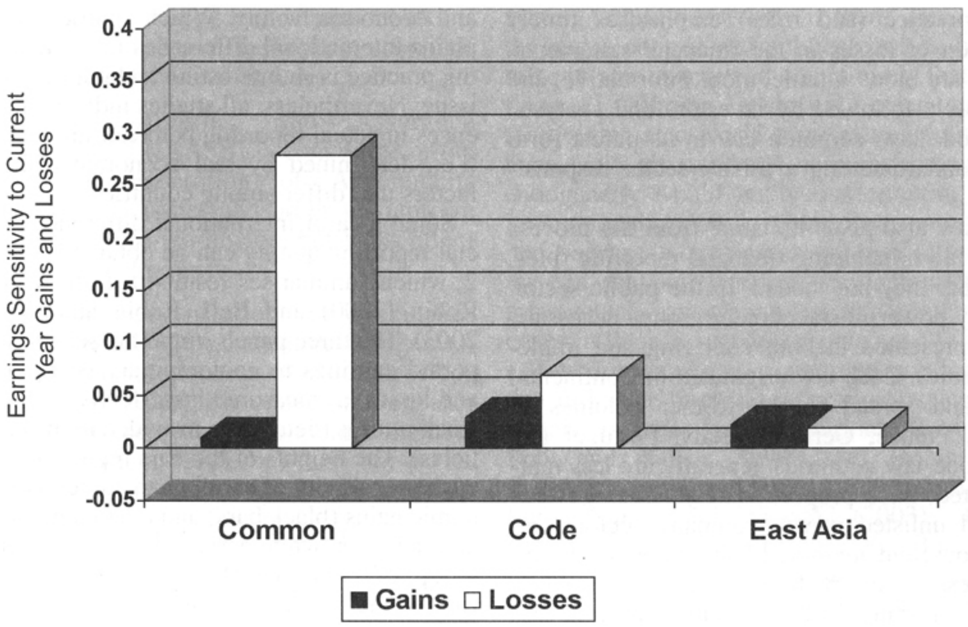
Panel A summarises the results for three country groups: common-law, code-law and East Asia. Panels B and C provide estimates for a selection of individual countries. Differences in financial reporting practice among the three groups are readily apparent. The most notable difference is the considerably higher sensitivity of earnings to contemporary economic losses in the common-law category. This evidence of timelier recognition of economic losses under common-law accounting is consistent with the greater emphasis on shareholder value in common-law countries.

The converse is especially relevant to doubts about the quality of IFRS implementation that will occur, over time, outside of common-law countries. Timelier loss recognition is less likely in countries where managers are more protected, and shareholders have a lesser role in governance, because it puts unwelcome pressure on managers to fix their loss-making investments and strategies

[30] Starting with Ball, Kothari and Robin (2000), researchers have been concerned that the estimates reported in Figure 2 could differ in reliability (or bias) across countries and groups, because they rely on share price data. While Ball, Kothari and Robin (2000: 48) note several reasons to discount this concern, researchers have developed other tests, which corroborate the price-based results. These include tests based on the time series of reported earnings (Ball and Robin, 1999; Ball, Robin and Wu, 2003) and accruals-based tests (Ball and Shivakumar, 2005; Bushman, Piotroski and Smith, 2006).

Figure 2
Timeliness of earnings historically has depended on countries' political and economic institutions

Panel A
Common-law, Code-law and East Asia country groups



Panel B
Some individual Common-law and Code-law countries

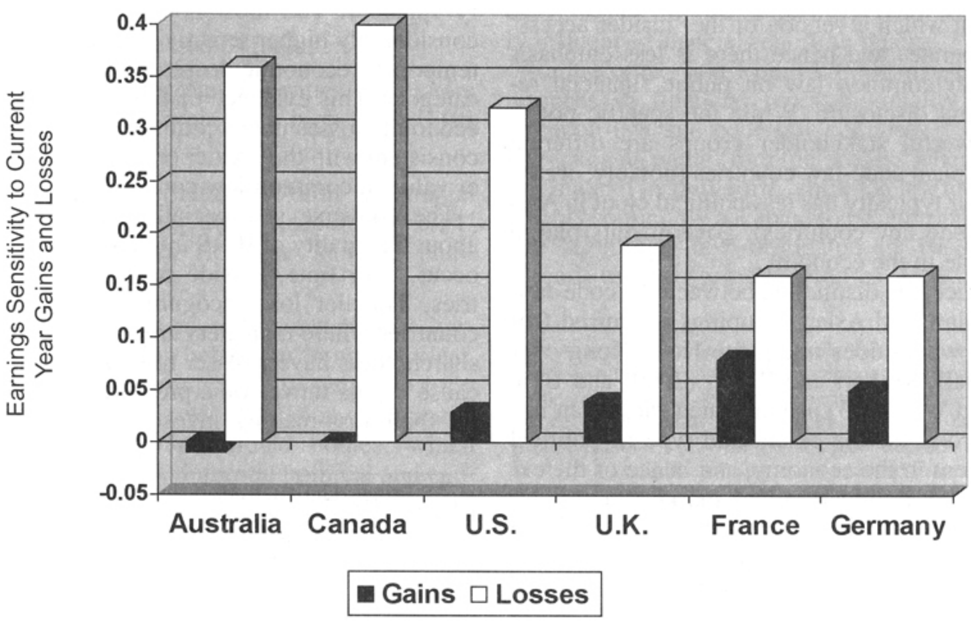
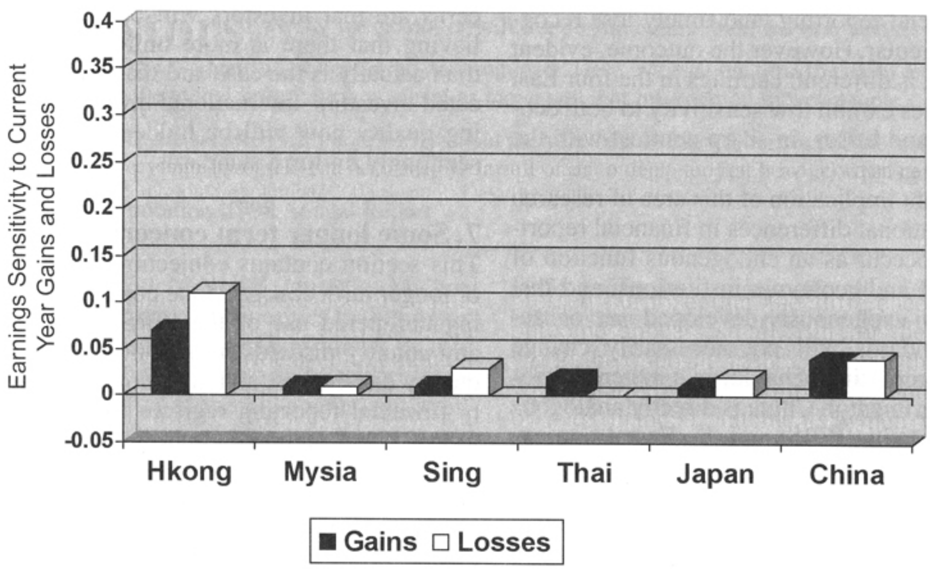


Figure 2 *(continued)*
Timeliness of earnings historically has depended on countries' political and economic institutions

Panel C
Some individual Asian countries



Sources: Ball, Kothari and Robin (2000); Ball, Robin and Wu (2000, 2003).

more quickly, and to undertake fewer negative-NPV investments in the first place. For example, timely loss recognition helps to curb managers' appetites for 'pet' projects and 'trophy' acquisitions that are socially wasteful and not in the shareholders' interests (Ball, 2001; Ball and Shivakumar, 2005). It is not surprising that loss recognition timeliness is lower on average in countries where individual shareholders are deemed less important and managers have more latitude to pursue their own preferences. The key implementation question is whether managers in countries whose systems are less responsive to the interests of shareholders will change their habits under IFRS, and exercise their subjective judgment to a greater degree in tying their own hands. I have my doubts.

China's experience provides a more direct source of evidence on the extent of IFRS implementation when it is imposed by governments, without change occurring in the fundamental economic and political factors affecting financial reporting practice. Ball, Robin and Wu (2000) study China's requirement that all domestic companies with foreign shareholders publish financial statements that conform to IFRS (then known as IAS) and that are audited by an international accounting firm. Many features of China's institutional environment militate against high-quality financial reporting, among them being the prevalence of 'insider' networks, the strong political roles of the Chinese government and army in the economy, and the absence of shareholder litigation rights. Ball, Robin, and Wu report that these institutional features appear to swamp the effect of mandating IAS. When reporting under international accounting standards, the financial statements of Chinese firms are no more timely in reflecting economic gains or losses than when reporting under local standards. This is shown graphically in Panel C of Figure 2, where the sensitivities of Chinese earnings to contemporary economic gains and losses (i.e., estimates of gain and loss recognition timeliness) resemble those of other Asian countries and are substantially lower than the common-law equivalents. China's experience with mandating IAS shows that it is difficult to achieve a noticeable improvement in financial reporting quality *in practice* by implanting exogenously developed accounting standards into a complex institutional environment.

Ball, Robin and Wu (2003) argue that a similar outcome is evident in the four East Asian countries

(Hong Kong, Malaysia, Singapore and Thailand) reported as a group in Panel A of Figure 2, and individually in Panel C. Accounting standards in these countries historically have been based on British standards, on US GAAP and more recently on IAS: that is, they have followed a fundamentally common-law model. If implemented fully, these standards should facilitate comparatively high-quality financial reporting, and timely loss recognition in particular. However the outcome, evident in the graphs, is different: earnings in the four East Asian countries exhibit low sensitivity to both economic gains and losses, in sharp contrast with the common-law group.

An important implication of this area of research is that international differences in financial reporting practice occcur as an endogenous function of local political and economic institutions, and that importing an exogenously-developed set of accounting standards will not necessarily change firms' actual reporting behavior in a material fashion. The experiment in China is directly analogous to the EU adopting IFRS, and the East Asian experience provides a useful precedent also. Like China and East Asia, Continental European countries have predominantly code-law institutional structures and preparer incentives. The experience of those countries in importing international standards derived from a common law view of financial reporting illustrates the difficulty of obtaining change in actual financial reporting practice by importing exogenously developed accounting standards into a complex political and economic environment.[31]

6.4. Uneven implementation: overview

Uneven implementation of IFRS seems inevitable. Accrual accounting (and fair value accounting in particular) involves judgements about future cash flows and thereby provides leeway in IFRS implementation. Powerful local economic and political forces determine how managers, auditors, courts and regulators respond to that leeway. Uneven implementation curtails the ability of uniform standards to reduce information costs and information risk. It could increase information processing costs, by burying accounting inconsistencies at a deeper and less transparent level than more-readily observable differences in standards. It threatens to curtail many of the potential benefits of IFRS adoption.

I believe implementation issues deserve far greater attention. There is an emerging academic literature on the topic.[32] Nevertheless, texts on national financial accounting and on international accounting usually contain elaborate expositions on accounting standards, but little on the incentives of preparers and how these systematically affect actual financial reporting practice.[33] The focus tends to be on what the rules say, not on how they are implemented in practice.

Implementation is the Achilles heel of IFRS. There are overwhelming political and economic reasons to expect IFRS enforcement to be uneven around the world, including within Europe. Substantial international differences in financial reporting quality are inevitable, and my major concerns are that investors will be mislead into believing that there is more uniformity in practice than actually is the case and that, even to sophisticated investors, international differences in reporting quality now will be hidden under the rug of seemingly uniform standards.

7. Some longer term concerns

This section contains conjectures on some issues of longer term concern. One concern is that allowing unfettered use of the IFRS 'brand name' by any country discards information about reporting quality differences, and does not allow high-quality financial reporting regimes to signal that they follow better standards than low-quality regimes. Another concern is that international standards reduce competition among alternative financial reporting systems, and hence reduce innovation. Finally, while the IASB and its promulgated standards historically have enjoyed – and currently do enjoy – a strong 'common law' orientation, over time the IASB risks becoming a politicised, polarised, bureaucratic, UN-style body.

7.1. The IFRS brand name problem

In the presence of local political and economic factors that exert substantial influence on local financial reporting practice, and in the absence of an effective worldwide enforcement mechanism, the very meaning of IFRS adoption and the implications of adoption are far from clear. In the enthusiasm of the current moment, the IFRS 'brand name' currently is riding high, and IFRS adoption is being perceived as a signal of quality. I am not sure how long that perception will last.

[31] Other evidence supports this conclusion. Leuz (2003) reports that the financial reporting quality of German firms listed on the New Market does not depend on their choice of US GAAP or IFRS (presumably it is determined by preparers' incentives, not by accounting standards). Ball and Shivakumar (2005) report substantial differences in reporting quality between U.K. public and private firms, despite them using identical accounting standards. Burgstahler, Hail and Leuz (2006) and Peek, Cuijpers and Buijink (2006) report similar evidence for wider samples of EU public and private firms.

[32] See: El-Gazzar, Finn and Jacob (1999), Street, Gray and Bryant (1999), Street and Gray (2001, 2002), Street and Bryant (2000), Murphy (2000), Aisbitt (2004) and Larson and Street (2004).

[33] See: Choi, Frost and Meek (1999), Mueller, Gernon and Meek (1997), Nobes (1992), Nobes and Parker (1995) and Radebaugh and Gray (1997).

Figure 3
An example of a costless (hence useless) signal about quality

Our Values

RESPECT: We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness, and arrogance don't belong here.

INTEGRITY: We work with customers and prospects openly, honestly, and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.

COMMUNICATION: We have an obligation to communicate. Here, we take the time to talk to one another ... and to listen. We believe that information is meant to move and that information moves people.

EXCELLENCE: We are satisfied with nothing less than the very best in everything we do. We will continue to raise the bar for everyone. The great fun here will be for all of us to discover just how good we can really be.

Source: Enron Corporation, 1998 Annual Report.

In a famous model, Nobel laureate Michael Spence (1973) introduced economics to the important problem of credibly signalling one's quality. He argued that when a user wants to know the quality levels of other economic agents, but available information about quality is imperfect, the higher-quality agents want to send signals to distinguish themselves from those who are lower-quality. But a signal will be credible to its recipient only if the costs of signalling are negatively correlated with actual quality. Unless it is more costly for the lower-quality agents to claim they are of high quality, they will join the high-quality agents in making that claim. If the equilibrium then is that every agent makes the same claim, the signal loses its informativeness. The only way to make a signal informative (i.e., obtain an equilibrium in which only the higher-quality agents signal they are of high quality) is for the system to incorporate a cost of signalling that the lower-quality agents are not prepared to pay.

Applying this reasoning to the hodgepodge of 100 or so IFRS adopters listed in Figure 1 is disquieting. If investors want to know the reporting quality levels of companies resident in a variety of countries, but do not have complete knowledge about the countries' quality levels, then higher-quality countries might want to choose IFRS to distinguish themselves from those of lower quality. But the problem with IFRS adoption, as a signal to investors about the financial reporting quality of a preparer, is that it is almost costless for *all* countries to signal that they are of high quality: i.e., to adopt the highest available accounting standards *on paper*. Worse, IFRS adoption most likely costs *less* to the lower-quality countries, for two reasons. First, the lower-quality regimes will incur fewer economic and political costs of actually enforcing the adopted standards. It is the higher-quality reporting regimes that are more likely to incur the cost of actually enforcing IFRS, because they have the institutions (such as a higher-quality audit profession, more effective courts system, better shareholder litigation rules) that are more likely to require enforcement of whatever standards are adopted. Second, by wholesale adoption of IFRS, the lower-quality regimes can avoid the costs of running their own standard-setting body, which likely are proportionally higher than in larger economies.[34]

The signalling equilibrium thus is likely to be that both the lower-quality and the higher-quality countries find it in their interest to adopt IFRS, so the adoption decision becomes uninformative about quality. Judging by the list of approximately 100 IFRS adopters, this is what has transpired. A classic 'free rider' problem emerges: it is essentially costless for low-quality countries to use the IFRS 'brand name,' so they all do. If IFRS adoption is a free good, what companies or countries will not take it? When it is costless to say otherwise, who is going to say: 'We will not adopt high standards'?

Figure 3 provides an example of a costless (and hence useless) signal about quality: Enron Corporation's stated code of ethics, denoted 'Our Values'. This set of high ethical standards was reported to the public in Enron's 1998 Annual Report, released early in 1999, at the height of the company's malfeasance in financial and energy markets. Relatively speaking, it costs little to adopt such standards and promote their adoption to the public. Enforcing the standards is another matter: in Enron's case, that would have involved not only the cost of inspection and audit of managerial behaviour, but also the cost to managers of forgoing opportunities to manipulate energy and capital markets.

[34] This has been claimed to be an advantage of IFRS. No doubt it is an advantage to the lower-quality adopters, but it is difficult to see it as a long term advantage to international financial reporting in general.

The only way to make the IFRS signal informative about quality is for the worldwide financial reporting system to incorporate a cost of signalling that the lower-quality agents are not prepared to pay. This would necessitate an effective worldwide enforcement mechanism, under which countries that adopt but do not effectively implement IFRS are either penalised or prohibited from using the IFRS brand name. In the absence of an effective worldwide enforcement mechanism (which I believe would be a bad idea for different reasons, discussed below), it is essentially costless for low-quality countries to use the IFRS 'brand name', and local political and economic factors inevitably will exert substantial influence on local financial reporting practice, IFRS adoption notwithstanding.

If allowing all countries to use the IFRS label discards the information in accounting standards about reporting quality differences, then the available quality signal could become the quality of the enforcement of standards, not standards per se. The major reason to expect enforcement – not mere adoption of standards – to be a credible signal is that it is more costly for low-quality countries to adopt high enforcement standards, because this would run counter to local political and economic interests. The Spence signalling model predicts a separation between low-quality and high-quality actors. One possibility thus is that high-quality financial reporting regimes will join a group whose member countries subject the enforcement standards of their companies to group inspection. This is one interpretation of the 'convergence' process being followed by the US, the outcome of which seems likely to be adopting essentially the same standards as IFRS, but without using the IFRS 'brand name'. The irony of these types of possible outcome is that IFRS might simply shift the dimension on which international differences and coalitions occur from accounting standards (as previously) to enforcement standards.

7.2. Competition and innovation among systems

Competition breeds innovation, encourages adaptation, dispels complacency and penalises bureaucracy. International competition among economic systems in general is healthy. Imposing worldwide standards therefore is a risky centralisation process in any sphere of economic activity. I am aware of no compelling reason why international competition among financial reporting systems is no less desirable than in other spheres, and should not be encouraged.[35]

I am particularly concerned about the long run implications of countries downgrading the resources and status of – and even eliminating – their national standard-setting bodies. I therefore am a keener advocate of 'convergence' than of outright IFRS adoption (yet another reason to suspect, or at least hope, that national differences will prevail over international uniformity).

7.3. Long-term politics, polarisation and bureaucracy

The final longer-term concern is the risk of the IASB (or its successor) becoming a representative, politicised, polarised, bureaucratic, UN-style body. The IASB and its promulgated standards historically have – and currently do – enjoy a strong 'common law' orientation. How long that will last is another matter.

The IASC was founded in 1973 by professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom and Ireland, and the United States. Since then, there has been a drift towards international representation. Currently, the International Accounting Standards Committee Foundation has six trustees from the Asia/Oceania region, six from Europe, six from North America and four from any region of the world. In spite of this drift, IFRS currently reflect a strong common-law philosophy.

The current membership representation and philosophy of the IASB seem likely to face challenges in the longer term. Over time, each of the 100 or so IFRS-adopting nations will have a politically-legitimate argument that they deserve some sort of representation in the standard-setting process. Do not the standards that are chosen by the IASB affect their countries, too?

8. Faith, hope and parity

Uniform reporting rules worldwide – parity for all – seems a great virtue. And there is no doubting that at least some convergence of standards seems desirable – and inevitable – in an increasingly globalised world. The adoption of IFRS by almost 100 countries, and the convergence processes currently underway, are testimony to increased globalisation – as well as to the quality and influence of IFRS.

Nevertheless, a note of caution is required, for reasons that include:

1. Internationally uniform accounting rules are a leap of faith, untested by experience or by a significant body of academic results.
2. The emphasis in IFRS on fair value accounting is a concern, particularly in relation to reporting in lesser-developed nations.
3. The incentives of preparers (managers) and enforcers (auditors, courts, regulators, politi-

[35] Arguments for international competition among accounting standards are made by Dye (1985), Ball (1995), Dye and Verrecchia (1995) and Dye and Sunder (2001).

cians) remain primarily local, and inevitably will create differences in financial reporting quality that will tend to be 'swept under the rug' of uniformity.

4. It is essentially costless to say one has the highest standards, so even the lowest-quality reporting regimes will be attracted to free use of the IFRS 'brand name'.

5. Uniform international standards reduce competition among systems.

6. The long run implication of global politics could well be that the IASB (or its long run successor) becomes a representative, politicised, polarised, bureaucratic, UN-style body.

Few would disagree that some degree of uniformity in accounting rules at every level – firm, industry, country, or globe – is optimal. Exactly how much is a long-unresolved issue. And few would dispute that widening globalisation of markets and politics implies some narrowing of rule differences among nations, though here too the optimal degree of uniformity is far from clear. IFRS adoption is an economic and political experiment – a leap of faith – and only time will tell what the pros and cons of IFRS to investors turn out to be.

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