The Effects of Mandatory IFRS Adoption in the EU: A Review of Empirical Research

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Foreword

In this report we summarise the findings of about 170 research papers on the effects of mandatory IFRS adoption in the EU. It is intended to assist interested parties in the debate on the future of IFRS in the EU by looking at what we can learn from empirical academic research on the costs and benefits of its implementation to date. It also provides a case study of the challenges involved in using empirical research to review the effects of major policy changes.

Views on policy issues come from diverse sources: empirical research – academic and non-academic, personal and anecdotal evidence, theories and prejudices. Nobody forms their views on major issues of public policy purely on the basis of academic research. But research should make it clearer what we do and do not know, and provide a surer basis for debate.

Although in this report we concentrate on academic empirical research, readers who look to such research evidence for clear and simple answers to complex policy questions will be disappointed. Much of the research on IFRS can be difficult to follow for those who are not mathematically inclined. It is founded on statistical techniques and arrives at conclusions that are expressed in terms of correlations, averages and probabilities. But where we are dealing with large populations, such techniques are essential. Individuals may know of particular cases where there were specific benefits or costs of IFRS adoption, but IFRS adoption affected thousands of companies over a number of years, and only statistical techniques can tackle problems on this scale.

Statistical techniques also impose greater rigour in establishing cause and effect. Personal experiences of apparent cause and effect can be deceptive. Links between smoking and cancer, for example, could not have been established by arguments between those who happened to know people who had smoked all their lives and never suffered any ill effects and those who knew smokers who suffered from cancer. Only statistical techniques can establish causal connections in such cases, and even then only as probabilities.

On many issues that arise from the EU’s adoption of IFRS, the evidence is unclear and different researchers arrive at different answers. This is usually because they have applied different tests or looked at different samples or at different periods. But such apparent contradictions make it difficult for the reader of research to draw conclusions.

Often the results are unclear because of confounding factors. The adoption of IFRS in the EU was not a laboratory experiment. The world outside continued to change as IFRS came into effect in the EU, and some of the changes were induced by the EU itself as it sought to reform its financial services and capital markets. Disentangling the effects of all these changes is one of the challenges of accounting research, and different researchers arrive at different conclusions as to which changes had which effects.

And on some important questions related to the effects of IFRS adoption, there is relatively little research evidence.

None the less, the report finds that there is evidence of benefits following IFRS adoption in relation to financial reporting transparency and comparability, the cost of capital, market liquidity, corporate investment efficiency and cross-border capital flows. But the evidence on some of these matters is disputed and it is unclear how far the benefits identified are attributable to the adoption of IFRS or to other concurrent institutional changes, particularly in enforcement. What is clear is that the benefits found are uneven, varying with the institutions and incentives that apply for different companies in different countries.

We welcome feedback on this report and the issues it raises, including from those whose research we have cited if they disagree with how we have summarised their work or with our comments on it. We intend to produce a second and final version of the report in 2015, and will take any feedback into account in that edition. Please send comments to bettermarkets@icaew.com.
Executive summary

Chapter 1: Introduction

With effect from 2005, compliance with IFRS was made mandatory in the EU for the consolidated accounts of companies with securities traded on a regulated market (‘publicly traded companies’) by Regulation 1606/2002. The Regulation also required EU Member States ‘to take appropriate measures to ensure compliance’. The Regulation’s objectives were: improved transparency and comparability, better functioning of the internal market, the efficient and cost-effective functioning of the capital market, the protection of investors and maintenance of confidence in capital markets, and helping EU companies compete on an equal footing for capital within the EU and on world capital markets.

The Regulation was opposed by some people at the time, and the impact of IFRS in the EU has remained controversial since its implementation, especially since the financial crisis.

Policy makers often say that they want to make policy based on evidence, and they may look to academic researchers to provide them with impartial and reliable evidence. The costs and benefits of mandatory IFRS adoption in the EU would appear to provide an ideal topic on which researchers might support the work of policy makers, and in this report we summarise and discuss the findings of empirical academic research on this controversial subject. There already exist several excellent surveys of research into the effects of IFRS adoption, but the distinctive contribution of this report is as follows:

- It expressly addresses the objectives of Regulation 1606/2002.
- Its scope is restricted, as far as possible, to evidence from the EU.
- It is about two years more up-to-date than the major previous surveys.
- It gives fuller summaries of the underlying research literature than the previous surveys.
- It excludes, as far as possible, the literature on the effects of voluntary IFRS adoption in the EU.

It is not possible, however, to draw indisputable conclusions on the overall effects of mandatory IFRS adoption based on the available research. Different researchers arrive at different conclusions. Their conclusions are often qualified or applicable only to some companies or some countries. Much research covers mandatory IFRS adopters around the world, not just in the EU, and sometimes it is uncertain how far its conclusions apply to the EU specifically. And on some important aspects of the subject there is very little research.

But as we discuss below in more detail, it seems likely that there were overall benefits to transparency, comparability, the cost of capital, market liquidity, corporate investment efficiency and international capital flows associated with the mandatory adoption of IFRS in the EU, although it is unclear how far these benefits should be attributed to concurrent institutional changes.

Chapter 2: Challenges for research and its interpretation

The effects of mandatory IFRS adoption in the EU are an important topic, but one that presents challenges both for researchers as to how to draw conclusions from a mass of sometimes opaque and unpromising data, and for the readers of research as to how its findings should be interpreted. We identify and discuss a number of specific issues that affect this area of research. These include significant challenges arising from concurrent changes in other institutions, whose effects it is difficult to disentangle from those of IFRS adoption. Indeed, as the introduction of IFRS in the EU was part of a larger package of reforms, the Financial Services Action Plan, some might argue that it is more useful to look at the effects of IFRS adoption in the context of the package as a whole.
The challenges for accounting research do not mean that it cannot help policy makers on questions such as the effects of mandatory IFRS adoption in the EU. But they do mean that such research can be extremely difficult and that its findings may well be complex. Research should discipline the debate on policy, making clear which views can and which cannot be supported by research evidence, and where the evidence is unclear.

Chapter 3: Transparency

Research evidence differs on whether mandatory IFRS adoption improved the overall transparency of EU companies’ financial reporting. On balance, the evidence suggests that there was an improvement, but that it was not experienced by all companies or in all countries. It is also unclear how far the improvement was attributable to concurrent changes in other institutions rather than to the adoption of IFRS.

Chapter 4: Comparability

Research evidence differs on whether mandatory IFRS adoption improved the comparability of EU companies’ financial reporting. On balance, the evidence suggests that there was an improvement, but there is also ample evidence of continuing incomplete comparability in certain respects. In part, this is because IFRS allows choices; complete comparability is therefore not to be expected. But there is also evidence of continuing financial reporting differences because of differences in institutions and incentives among firms and countries.

Chapter 5: The cost of capital

Research evidence differs on whether mandatory IFRS adoption reduced the cost of equity and debt capital for EU companies. On balance, the evidence suggests that there were reductions in the cost of equity capital and in the cost of bonds, but that they were not experienced by all companies or in all countries. It is also uncertain how far the improvements were attributable to concurrent changes in other institutions rather than to the adoption of IFRS. The effects of mandatory IFRS adoption in the EU on the cost of loans, as opposed to bonds, are unclear.

Research evidence indicates that the stock market anticipated the effects of mandatory IFRS adoption, which makes the measurement of these effects, where they include stock market data, less certain.

Chapter 6: Market liquidity

Research evidence differs on whether mandatory IFRS adoption increased the liquidity of the equity market for EU companies as a whole. On balance, the evidence suggests that there was an increase, but that it was not experienced in relation to all companies or all countries. It is also unclear how far the increase was attributable to concurrent changes in other institutions rather than to the adoption of IFRS. We are not aware of any research on the effects of mandatory IFRS adoption in the EU on liquidity in bond markets.

Chapter 7: Corporate investment efficiency

While the subject has not been heavily researched (we have identified just five papers), the available evidence suggests an improvement in the efficiency of corporate investment following mandatory IFRS adoption. It is not clear how far the papers on this subject have allowed for the possibility that other concurrent institutional changes in the EU intended to increase the efficiency of capital markets may be relevant to their findings.

Chapter 8: Cross-border investment

Researchers appear to agree that there was increasing cross-border investment – both foreign direct investment and foreign portfolio investment – following mandatory IFRS adoption, but also agree that it was not experienced uniformly by all companies or all
countries. Again, it is not clear how far the papers on this subject have allowed for the possibility that other concurrent institutional changes in the EU may be relevant to increases in cross-border capital flows.

Chapter 9: Other benefits

There is research evidence suggesting a number of other possible benefits of mandatory IFRS adoption:

- reduced expropriation risk (i.e., the risk that outsiders’ share of a firm’s income and wealth will be expropriated by insiders);
- increased trade within the EU;
- increased use of accounting information of foreign peer companies in monitoring managers’ performance (i.e., in deciding how much they should be paid and whether they should be replaced); and
- reduced risk of stock market price crashes.

None of these topics is heavily researched (usually there are just one or two papers on each question), and in some cases it would be wrong to put much weight on the findings, particularly in those instances where much of the evidence comes from outside the EU.

Chapter 10: Costs

There is little research evidence on the continuing incremental costs of IFRS for preparers. But there is evidence of some other, possibly unexpected costs (i.e., negative effects) of IFRS adoption:

- reduced use of accounting-based measures in managers’ pay contracts;
- reduced use of accounting-based covenants in debt contracts;
- wealth transfers, in both directions, between shareholders and lenders;
- changes in capital structure that would not otherwise have been made;
- capital issues that would not otherwise have been made; and
- changes for the worse in some aspects of risk management using financial instruments, although these may well be accompanied by other changes for the better.

None of these topics is heavily researched (just one or two papers on each question), and again in some cases it would probably be wrong to put much weight on the findings, particularly in those instances where much of the evidence comes from outside the EU.

Chapter 11: The financial crisis

While to date there is no research evidence that financial reporting was a significant contributor to the banking crisis in the EU, more research based on EU financial institutions is needed before conclusions can be drawn on this question.

Evidence from the US suggests that financial reporting requirements for the use of fair value did not have a significant role during the crisis, but this conclusion is not necessarily applicable to the EU.

We are not aware of any research into the potential role of fair value accounting or the incurred loss method of loan-loss provisioning in the years before the crisis either in the US or the EU.
Chapter 12: Conclusions

The research evidence on the potential benefits of mandatory IFRS adoption in the EU is generally not conclusive. But on balance it seems likely that there were overall benefits to transparency, comparability, the cost of capital, market liquidity, corporate investment efficiency and international capital flows. The research evidence also clearly shows that these benefits were unevenly distributed among different firms and different countries. Due to differences in institutions and incentives, there may have been either negligible benefits or even costs rather than benefits for particular firms or countries.

The research evidence that supports these conclusions is often drawn from databases that are focused on larger publicly traded companies, which may impart a bias to the findings, but it is not clear in which direction. One effect of this sample bias is that eastern European companies are often under-represented in international research on the effects of IFRS adoption.

It is unclear how far the benefits found to follow mandatory IFRS adoption are attributable to the change of financial reporting standards or to concurrent changes in other institutions.

There is virtually no research evidence on some other costs that may have been incurred by firms, eg, increased preparation costs. Partly for this reason, overall conclusions on net costs and net benefits do not emerge from the research findings.

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As financial reporting reform is part of a broader package of institutional reforms, its success may be judged in part by its effects on surrounding institutions, and this success may also be determined by changes (or the lack of them) in surrounding institutions.

For researchers, there remain plenty of unanswered questions surrounding the effects of IFRS adoption in the EU:

- Where existing findings appear to contradict one another, it would be helpful to investigate why this is the case so that apparent anomalies in the research record are either removed or explained.

- It would be helpful to know more about a number of important questions on which little is currently known, such as the role of financial reporting in relation to the financial crisis, and the effects of IFRS adoption in eastern Europe.

- The links between financial reporting and its surrounding institutions need further exploration. In particular, although important work has been done to explore some of the connections between financial reporting changes, concurrent institutional changes and capital market effects, this might profitably be extended to cover other possible effects of IFRS adoption.

For policy makers, the research findings summarised in this report will not end controversy on the effects of IFRS adoption in the EU, but they should help to form views on what has been achieved to date and what needs to be done in the future. Perhaps the most significant point to emerge from the research is the importance of institutions and incentives. The balance of evidence suggests that the objectives of Regulation 1606/2002 have been achieved to some extent. But differing institutions and incentives inevitably mean that its effects vary from firm to firm and from country to country. And the objectives may well have been achieved to some, at present undetermined, extent by concurrent institutional changes forming part of the Financial Services Action Plan.

If the EU wishes to achieve further progress in financial reporting and to reap the benefit of these improvements, it may make most sense to look at the incentives for those involved in
the financial reporting process and at the institutions that surround it, as well as to engage in the global debate on the future development of IFRS.

There are also more general lessons for policy makers who wish to base their decisions on research evidence:

- Where researchers arrive at findings that are apparently inconsistent with previous research, sometimes they try to explain the inconsistencies, but sometimes they do not. No doubt the differences are usually attributable to differences in samples, in periods covered and in methodologies. Investigating differences may be difficult and time-consuming, and the incentives for researchers to do so appear to be weak. It may therefore be worthwhile for policy makers to commission additional research specifically to look into and explain such apparent anomalies.

- Some topics in relation to the effects of IFRS adoption that are of interest to policy makers in the EU are under-researched. Where policy makers know that they will need to make or review decisions, and wish to be able to rely on research in doing so, they may need to take a more active approach to ensuring that all relevant aspects of the question have been adequately researched.