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IFRS in the EU: what research tells us

A Briefing Paper

INFORMATION FOR BETTER MARKETS INITIATIVE

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With effect from 2005, and in accordance with Regulation 1606/2002, compliance with International Financial Reporting Standards (IFRS) was made mandatory in the EU for the consolidated accounts of companies with securities traded on a regulated market. 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.

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 clarify what we do and do not know, and provide a surer basis for debate. Indeed, policymakers 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.

Regulation 1606/2002 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. The costs and benefits of mandatory IFRS adoption in the EU therefore appear to provide an ideal topic on which researchers might support the work of policymakers, and in a new report, *The effects of mandatory IFRS adoption in the EU: a review of empirical research*, on which this briefing is based, we summarise and discuss the findings of about 170 research papers on this controversial subject.

Although in the 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 issues 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 improve the enforcement of financial reporting requirements and 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 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, for example, whether it leads to a change in the sources of finance for business (towards more international, publicly traded and outsider financing). This success may also be determined by changes (or the lack of them) in surrounding institutions.

On some important aspects of the effects of IFRS adoption, there is relatively little research evidence.

For all these reasons, the research evidence on the effects of mandatory IFRS adoption in the EU is generally inconclusive. But on balance it seems likely that, following adoption, 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 negligible benefits, or even costs, rather than benefits for particular firms or countries. And 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.

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 result of this sample bias is that eastern European companies are often under-represented in international research on the effects of IFRS adoption.

IFRS adoption also appears to have had some unintended consequences, for example, reducing the use of accounting-based terms in loans and remuneration agreements. This perhaps reflects the International Accounting Standards Board's (IASB) focus on information for valuation purposes, at the expense of information for contracting.

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

While to date there is no research evidence that financial reporting was a significant contributor to the banking crisis in the EU, more work based on EU financial institutions is needed before conclusions can be drawn on this major policy question. In particular, research is needed into how financial reporting practices, such as the use of fair value and the incurred loss method of measuring loan impairments, might have affected banks' decision making in the years before the crisis.

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 can be 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. Important work has been done to explore some of the connections between financial reporting changes, concurrent institutional changes and capital market effects. But this might profitably be extended to cover other possible effects of IFRS adoption.

For policymakers, the research findings summarised in the 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.

If the EU wishes to achieve further progress in financial reporting and 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.

The effects of mandatory IFRS adoption in the EU: a review of empirical research is available from icaew.com/bettermarkets. We welcome feedback on the report and the issues it raises. We intend to produce a second and final version of the report in 2015, and will take any feedback into account in that edition.

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