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**Analysis of a Worldwide Adoption
of the International Financial Reporting Standards**

Diploma Thesis


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Declaration of Authorship

I hereby confirm that I have written the thesis “Analysis of a Worldwide Adoption of the International Financial Reporting Standards” by myself and independently and that I have mentioned all the literature and other sources appropriately in the list of references.

In Baku as of 9 September 2013

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Abstract

The main purpose of the thesis is to analyze the effects of International Financial Reporting Standards on preparing the financial statements and its attractions for the foreign capital both in EU and other selected countries such as Russia and China. The first part of the thesis is focused on an explanation of an early history of IASs and IFRSs including reasons for an adopting the IFRSs, direct and indirect advantages of IFRSs for investors, main indicators of IFRSs in preparing financial statements – fair value accounting and the problems in its implementation. There is a description of an adoption process of IFRSs in a worldwide with emphasize on EU - voluntary adoption at the beginning, mandatory adoption since 2005 and its quality added to the preparation of financial statements in the second chapter. The third part of the thesis includes an assessment of IFRSs adoption in selected countries such as Russia and China. Furthermore, I provide information how the culture and environment of countries affected the adoption of IFRSs and preparation of the financial statements according to international standards. All information used in the paper is gathered in the conclusion and put the final conclusion about all the points stressed on previous chapters.

Key words: IFRS, financial statements, EU, Russia, China

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Content

Introduction.....	1
1. Early history of IFRSs/IASs - Origins and overview of the IASB.....	4
1.1 IFRSs adoption effects on financial statements.....	4
1.2 IFRSs adoption effects on firms' management and decision-making processes.....	4
1.3 Why is there a need for international convergence in accounting standards?.....	5
1.4 Reasons for adopting IFRSs.....	6
1.4.1 Net economic value of IFRSs.....	6
1.4.2 Net political value of IFRSs.....	7
1.5 Advantages of the IFRSs for investors.....	9
2. Progressive adoption of the IFRSs in the world with emphasis on EU - mandatory and voluntary adoption.....	18
2.1 Early history of IASs/IFRSs.....	18
2.2 IFRSs - Form, quality and content.....	20
2.3 The overview of IASB.....	23
2.4 Voluntary adoption of IASs in the 1990s.....	25
2.4.1 Properties of IASs versus other national standards.....	25
2.4.2 Economic consequences of voluntary IASs adoption.....	27
2.4.3 Mandatory adoption of IFRSs in the EU.....	28
2.5 Conservatism and mandatory adoption of IFRSs.....	34
3. Assessment of adoption in selected countries and pros and cons on financial reporting. Analysis of differences among financial statements prepared by entities from selected countries – effects of culture and history on adoption.....	40
3.1 Russia.....	40
3.1.1 Problems of implementing international standards in Russia.....	42
3.1.2 International standards in Russia.....	45
3.1.3 Corporate governance in Russia.....	49
3.2 China.....	51
3.2.1 Development of Chinese stock market.....	52
3.2.2 Accounting standards in China.....	53
3.2.3 Other capital market structures in China.....	54
Conclusion.....	57
References.....	60

Introduction

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systemized form of accounting regulation developed in Europe in 1673. Here a requirement for annual fair value statement of financial position was introduced by the government as a means of protecting economy from bankruptcies. This form of accounting at the initiative of the state to control economic actors was copied by other states and later incorporated in 1807 Napoleon Commercial Code. Later it was expanded in other countries partly through enforcement of Napoleon or the willingness of other states voluntarily. This code law practices were much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on business profits started to be introduced, mostly in early 20th century.

The other model did not appear until 19th century and arose as a consequence of industrial revolution. Industrialization created the need for large concentrations of capital to undertake industrial projects (initially canals and railways) and to spread risks between investors. In this model the financial report provided a means of monitoring the activities of large businesses in order to inform their shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanctions of courts. This approach was rapidly adopted by US. As US developed the idea of groups of companies controlled from head office (towards the end of 19th century), this philosophy of financial reporting began to become focused on consolidated accounts and group rather than individual accounts. For different reasons neither the UK nor USA governments saw this reporting framework as appropriate for income tax purposes and in this tradition, while the financial reports inform the assessment process, taxation retains as separate stream of law which has had little influence on financial reporting.

The second model of financial reporting is in general Anglo-Saxon financial reporting approach and it can be characterized as focusing on the relationship between the business and investor and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (for example US SEC's mission is to protect the investor and ensure that securities markets run effectively), but the financial report is aimed at investor, not the government.

Neither of above models is particularly useful in agricultural economy, or to one that consists of entirely microbusiness, in the opinion of many observers. But however the countries which have developed industrially have already adopted the variances of these two models.

The stated goal of the IFRSs is to develop, in the public interest, a single set of high quality, understandable, enforceable, globally accepted financial reporting standards based upon clearly articulated principles.

Agoo there were scores of unique sets of financial reporting standards among the more developed nations (National GAAP). The year 2005 marked the beginning of new era in the global conduct of the business, and the fulfillment of thirty year effort to create the financial reporting rules for a worldwide capital market. For during that year's financial reporting cycle the 27 European countries and others, such as Australia, New Zealand and South Africa adopted IFRSs.

Since then many other countries, such as Argentina, Brazil, Korea, Canada, Mexico and Russia have adopted IFRSs. China has substantially converted their national standards in line with the IFRSs. All other major economies such as Japan and US have established the timelines to converge with or adopt IFRSs in their near future.

Years 2007 and 2008 proved to be watershed year for growing acceptability of IFRSs. In 2007 one of the most important developments was that US SEC dropped the reconciliation (US GAAP) requirement that had formerly applied to foreign private registrants: thereafter those reporting in a manner fully compliant with IFRSs (i.e. without any exceptions to the complete set of standards imposed by IASB) do not have to reconcile net income and shareholder's equity to that which would have been presented under US GAAP. In effect the US SEC was acknowledging that the IFRSs were fully acceptable as a basis for accurate, transparent, meaningful financial reporting.

This easing of US registration requirements for foreign companies seeking to enjoy the benefits of listing their equity or debt securities in the US led, quite naturally, to a call by domestic companies to permit them to also freely choose between financial reporting under US GAAP and IFRSs. By late 2008 the US SEC had begun the process of acquiescence, first for large companies in those industries having worldwide the preponderance of the IFRSs adopters and later for all publicly held companies. A new US SEC chair took office in 2009, expressing a concern that the move to IFRSs, if it were to occur, should perhaps move more slowly than that had been previously indicated. However that was author's opinion that maybe at the beginning there would be minor delay in the reporting of large companies. But at the end it would benefit for the whole economy for attracting foreign investment and raising the capital.

It had been highly probable that non-publicly held US companies would have been remained bound to US GAAP for foreseeable future, both from habit and because no other set of standards would be viewed as being acceptable. However the body that oversees the private sector auditing profession's standards in the US amended its rules in 2008 to fully recognize IASB as an accounting standard setting body (giving the equal status with FASB), meaning that auditors and other service providers in USA may now provide other level of assurance as specified under pertinent guidelines on the IFRSs- based financial statements. This change coupled with the promulgation by IASB of a long sought standard providing simplified financial reporting rules for privately held entities has probably increased the likelihood that a broad move to the IFRSs will occur within next several years. US SEC commissioner and chair have confirmed that they are committed to a single set of global standards and are still considering the incorporation of the IFRSs in the US for US issuers.

The impetus for the convergence of historically disparate financial reporting standards has been, in the main to facilitate the free flow of capital, so that, for example, investors in US will be more willing to finance business in say, China and Czech Republic. Having access to financial market which has the same language would help to US investors to mitigate the "accounting risk". The historic 2002 Norwalk Agreement – between the US standard setter, FASB and the IASB – called for "convergence" of the perspective sets of standards and indeed a number of revisions of either US GAAP or IFRSs have already taken place to implement this commitment with more changes expected in the immediate future. The aim of Boards was to compete milestone projects of the Memorandum of Understanding (MOU) by the end of June 2011.

Although the Boards were committed to compete the milestones projects by end of June 2011, certain projects such as financial instruments (impairment and hedge accounting), revenue recognition, leases and insurance contracts have been deferred due to the complexity of the projects and obtaining consensus views.

International Accounting is a field of academic interests which has significantly risen in the last couple of years. As such, it triggered heated debate among economists for putting forward different issues arising from the still vague boundaries of this scientific and practical area. The latter becomes important especially in emphasized conditions of international integration of firms, which in turn, provides them with more opportunities to approach new markets and

therefore to increase their sales and of course to obtain financing from the multinational financial markets. The last is accompanied with many obstacles. From the view of the accounting, outrunning those impediments calls for harmonization of international accounting. Rudhede and Wahlberg (2003) accentuate the lack of accounting synchronization and relate this with the investors' and companies' difficulties in understanding the variety of accounting principles among countries. Hence, a supranational entity is needed to be titled for preparing, issuing and interpreting internationally accepted rules for the accounting practice. Such body is The International Accounting Standards Board, which is "*committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements.*" (IASB, 2002, p.1).

International Accounting Standards, though, create a common language for defining, interpreting and publication of financial statements in the whole world.

Furthermore, their aim is to provide a standardized and coherent sight of the companies to the shareholders and investors. Establishing International Accounting Standards should enhance firms' performance in many ways. Houston and Reinstein (2001) point out that international accounting harmonization will trim down the costs of doing business, especially across national borders than will contribute towards greater efficiency of the market regulations and will reduce the costs for conducting financial statements analysis and investments in international context. For the purposes of this paper, the effects of International Accounting Standards' (IASs) adoption on firms are considered in two directions: their impact on the firms' management and their influence on financial statements.

In first chapter, firstly, I will explain effects of IASs adoption on financial statement and then I will explain effects of IASs adoption on decision making process of management. I will also try to explain the reasons for adopting the IFRSs - its direct and indirect advantages for investors.

In second chapter I will stress on worldwide adoption of IFRSs with emphasize on EU. Firstly I will describe the early situation in which the companies were willing to accept the IASs voluntarily, and later I will talk about the mandatory adoption of IFRSs in EU since 2005.

In third chapter I will talk about the assessment of IFRSs adoption in selected countries- especially in Russia and China. I will describe the history of local standards in selected countries and transition period to international accounting standards and problems occurring during this transition process.

Chapter 1

Early history of IFRSs/IASs - Origins and overview of the IASB

1.1. IFRSs adoption effects on financial statements

Although IFRSs adoption effects could be considered in many ways, the core IFRSs influence on a firm which has accepted and implemented them is to its financial statements. “Examining financial statement implications is important because, while IFRSs adoption might lead to indirect economic consequences ... the only direct effects ... are changed financial statements ...” (Hung and Subramanyan, 2004, p.4). Indeed, many companies accepting IFRSs face with the facility to implement new accounting definitions and valorization principles and procedures than to acquire more exhaustive and detailed reporting for their operations and activities and finally to satisfy the needs for a variety of financial statements’ users (Blanc, 2003). Besides these facilities by not allowing the creation of hidden reserves, IFRSs make financial statements more credible (Dumontier and Raffouriner, 1998). Some articles (Hung and Subramanyan, 2004 and Barth et al, 2005) have examined the effects of adopting IFRSs on financial statements, particularly on some accounting measures and financial ratios. For that purpose, for instance, Hung and Subramanyan (2004) have used a sample of 80 firms in Germany that have adopted IFRSs for the first time and found some significant results. Specifically, they found that the total assets and the book value of equity are considerably higher under IFRSs and that the latter plays more significant, while the former less significant “valuation role under IFRSs” (Hung and Subramanyan, 2004, p.36). Finally, they have concluded that “IFRSs emphasize fair values and balance sheet valuation”. In the same line of thinking, Barth et al (2005) found that companies that have adopted IFRSs experience more volatility in net income. Further, they found that these firms “evidence less earnings management, more timely loss recognition and more value relevance of accounting amounts”, compared with firms that haven’t adopted IFRSs.

1.2. IFRSs adoption effects on firms’ management and decision-making processes

Even though the main objective of the IFRSs is achieving convergence in presenting fair picture for the businesses through their financial statements, however, accepting IFRSs has broader impact on firms. For instance, Karamanou and Nishiotis (2005) found that adopting IFRSs, because of the higher disclosure required, is associated with viewing the firm as entity with high value. Moreover, this is considered as reputation building effect (Karamanou and Nishiotis, 2005). Wilson (2001; cited in Rudhede and Wahlberg, 2003) emphasizes the improved market communication of the firm which has adopted IFRSs, because every disclosure should be further explained by the management. Deepening the last conclusion, it infers that by adopting IFRSs, management becomes more accountable for running the business and its results. Following this line of thinking on the other hand IFRSs adoption could be considered in regards to the management and decision making processes in the firm itself.

For example, Mr. Boseski, a financial manager in a company which has adopted IFRSs some years before, compared management and decision making process in the firm which he works for, before and after IFRSs adoption. According to him, the main advantage of accepting the IFRSs for the firm’s management process is the availability of relevant, crucial and accurate information, which in turn are the platform for making good and accurate decisions. Indeed, compliance to IASs in the firm provided “more understandable, comparable, unified and valid information for the assets, liabilities, equity, revenues and costs”, said Mr. Boseski (Wilson 2001) and therefore enabled solid basis for acquiring valid information for the firm. Moreover, according to him, this further afforded investors to make more reliable estimations for the firm when they attempted investing in it last year. Literature also (Dumontier and Raffouriner, 1998)

supports this view, emphasizing that the IFRSs-complied firm supplies superior information, which in turn helps in attaining better financing conditions. “Another important area where IASs adoption was effectuated in our case was the opportunity of other firms – our business partners, which have adopted IASs also, to precisely assess our company, in regards to the potential risk in the business relations, but also in regard to the possibility of eventual further mergers and making our business activity broader in the future” – says Mr. Boseski (Wilson 2001). Moreover, the IFRSs adoption facilitated the firm in making comparisons with the competitors on a sustainable basis; this further evoked confident information for its position in the branch.

In the above line of thinking, some articles (Karamanou and Nishiotis, 2005; Easley and O’Hara, 2004 and Gebhardt et al, 2001) found that greater disclosure under IFRSs decreases the cost of capital. For instance, Easley and O’Hara (2004, cited in Karamanou and Nishiotis, 2005) state that firms that applied IFRSs have the opportunity to impinge on their cost of capital, through the IFRSs selection and the adopted policies of corporate disclosure. Furthermore, Gebhardt et al (2001) confirmed that firms with accurate information provided on IFRSs basis, “enjoy a lower implied cost of capital”. At the end of the interview, Mr. Boseski agreed that IFRSs adoption added value to the firm, but the main implications of IFRSs adoption, according to him, are better firm’s financial reporting and decreased cost for financial statements’ preparation.

Barth et al (2005) supports the view that adopting IFRSs improves financial reporting. In fact, all above discussion has its root in the firm’s financial statements’ preparing and reporting. Thus, much more attention in the following sections is devoted to the IFRSs impacts on financial statements.

1.3. Why is there a need for international convergence in accounting standards?

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 fiber-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. Until some years ago, 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 labor 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 internationalization 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.

1.4. Reasons for adopting IFRSs

In this sub-section I develop the arguments for and against IFRSs adoption. My analysis focuses on IFRSs as developed and sponsored by the IASB starting 2002, and specifically excludes International Accounting Standards promulgated by the IASB's predecessor, the International Accounting Standards Committee (IASC).

I develop my hypotheses around the IFRSs adoption decisions of both EU and non-EU countries.

Moreover, the EU member states committed jointly to adopting IFRSs (EC, 2002) making an analysis of their individual adoption decisions infeasible. Finally, there is evidence that the development of institutions and practices of the IASB are made in consultation with the EU. In subsequent univariate tests, I provide evidence on the differences between EU countries and the rest of my sample along adoption determinants identified below.

1.4.1. Net economic value of IFRSs

I describe the net economic value of IFRSs to a country as arising out of two factors:

1. The value from having a shared body of accounting standards; and
2. The relative quality of local governance institutions.

The value from having a shared body of accounting standards: IFRSs are developed specifically for wide international use. Proponents of IFRSs argue that by adopting a common body of international standards, countries can expect to lower the cost of information processing and auditing to capital market participants. More preparers, users, and auditors of financial reports can be expected to become familiar with one common set of international accounting standards than with various local accounting standards. If the adoption of IFRSs is expected to lower information costs to capital markets, we can expect countries more dependent on foreign capital and trade to value these economic benefits more. Absent international accounting standards, foreign investors must incur costs of becoming familiar with domestic accounting practices. These costs are likely to be passed on (at least in part) to the investment-destination country. If adopting IFRSs is expected to lower such costs, then it can be expected countries that are dependent on foreign capital to do so.

Similarly, countries where foreign trade is an important part of the economy can be expected to adopt IFRSs. Related to the point above, it can be argued that countries choose to adopt IFRSs when they expect to increase the share of foreign capital and trade in their economy. Expected foreign involvement in an economy can make current adoption of international standards more attractive. In this sense, even countries with low *levels* of foreign capital and trade can choose to adopt IFRSs if they are expecting *growth* in those factors. Adopting IFRSs to lower information costs is conceptually distinct from adopting IFRSs due to its "network benefits." Conceptually, "network benefits" refer to idea that IFRSs become more appealing as more countries adopt it; whereas adopting IFRSs to lower information costs refer to the standards' potential "platform benefits."

The relative quality of local governance institutions: Furthermore I expect the relative quality of local accounting standards to be an important determinant in the decision to adopt the IFRSs. Local accounting standards are part of a complex system of governance institutions that include auditor training, auditing standards, enforcement (regulatory and judicial), precedent for the protection of property rights, government corruption, and the role of the press, among others. Thus, in studying the IFRSs adoption decision, I consider jointly the relative quality of local accounting standards and that of associated governance institutions. Adopting the IFRSs can be costly if these institutions are collectively not compatible with the international standards. The relative quality of extant governance institutions refers to the ability of these institutions to facilitate the efficient allocation of capital in an economy.

In countries where the quality of extant governance institutions is relatively high, IFRSs adoption is likely to be less attractive. High quality institutions represent high opportunity and switching costs to adopting international accounting standards. The opportunity costs arise because in adopting the IFRSs, countries forgo the benefits of any past and potential future innovations in local reporting standards specific to their economies. IFRSs, by definition, are the result of international political economy equilibrium and thus cannot be expected to provide reporting standards that are uniquely suited to any given country's circumstances. The switching costs arise because countries with well developed governance institutions are likely to have well developed capital markets, and thus more market participants needing retraining in IFRSs. For countries where local governance institutions are not well developed, the prediction on IFRSs adoption is more nuanced. On one hand, opportunity and switching costs in these countries are lower, so the chance to adopt an externally developed body of accounting standards presents an advantage. On the other hand, such countries are likely to suffer from corrupt, slow-moving, or ineffectual governments that are resistant to or incapable of change. At the extreme, countries with weak institutions are failed states, where the adoption of the IFRSs is unlikely to be of any interest or consequence. Thus, among countries with less developed institutions, the decision to adopt the IFRSs is likely to be driven by lower opportunity and switching costs only if such countries are in fact capable and willing to make cost-benefit tradeoffs.

1.4.2. Net political value of IFRSs

The adoption of IFRSs by a country also involves trading off the potential gain from being able to influence international standard setting against the value lost from surrendering local authority over accounting standards. I describe the tradeoffs between these benefits and costs as constituting the net political value of IFRSs to a country. I classify the net political value as arising from two factors:

1. International power politics; and
2. Culture politics.

International power politics:

Ceteris paribus, it should be expected more powerful countries to have a larger positive political value since more powerful countries are more likely to be able to influence the nature of international standards. The influence of powerful countries can be the result of explicit lobbying and pressure tactics or the result of the IASB implicitly catering to powerful interests when developing standards.

The dominant position of the EU in IFRSs standard setting presents, however, an important constraint that is likely to alter the prediction above. As noted earlier, the development of IFRSs is strongly linked to support from the EU. The IASB is physically situated within the EU, and to date, the EU remains the IASB's largest supporter. As an evidence of it we can see that in 2005 EU passed the regulation for all listed companies preparing the financial statements on based of IFRSs.

If a country chooses to adopt IFRSs, it must either engage in the political process to try to shape the nature of the international standards or cede the standard setting role to other political players. It is unlikely that more powerful countries will adopt the latter route; however, if they choose to engage in the political process, they will likely have to enter into costly political wrangling with the EU. Faced with this choice, it is reasonable to expect that more powerful countries are less likely to adopt IFRSs. On the other hand, for less powerful countries, there is little political face lost in adopting EU-centric standards. Thus, *ceteris paribus*, I can predict that less powerful countries are more likely to adopt IFRSs. For example in table below the list of African countries is shown which have already adopted the IFRSs. As we can see in the table in countries like Botswana, Egypt, Ghana, Kenya, Libya and Nigeria IFRSs are required for all

companies. But in Burkina Faso, Eritrea, Liberia, Madagascar and Morocco IFRSs are required for some. In countries like Benin, Lesoto and Mali IFRSs are permitted but not required. And Angola, Algeria, Burundi, Cameroon and Gabon there is partial adoption of IFRSs.

Table 1: Countries that have adopted IFRSs in Africa

N	Country	IFRSs not permitted	Partial Adoption	IFRSs permitted	IFRSs required for some	IFRSs required for all	Year legally accepted/started to adopt
1	Angola		X				2009
2	Algeria		X				2009
3	Benin			X			2008
4	Botswana					X	2007
5	Burkina Faso				X		2012
6	Burundi		X				2004
7	Cameroon		X				2009
8	Egypt					X	2006
9	Eritrea				X		2010
10	Ethiopia		X				2009
11	Gabon		X				2009
12	Ghana					X	2007
13	Kenya					X	2002
14	Liberia				X		2012
15	Lesoto			X			2001
16	Libya					X	no date
17	Mali			X			2010
18	Malawi					X	2001
19	Morocco				X		2004
20	Mozambique			X			2006
21	Namibia					X	2005
22	Nigeria					X	2010
23	Rwanda					X	2008
24	Seychelles			X			2009

Source: International Financial Reporting Standard (2013) available at <http://www.adoptifrs.org>

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Culture politics:

In addition to country-level power politics, the perception of IFRSs as a European institution is likely to affect the international standards' acceptance in a country. In countries that are culturally more accepting of European institutions, international accounting standards can be more politically feasible. In countries where European institutions are non-native, adoption of IFRSs can be viewed as abrogating authority to a European standard-setter. Thus, *ceteris paribus*, I predict countries that are culturally closer to Europe are more likely to adopt IFRS.

1.5. Advantages of the IFRSs for investors

Direct IFRSs advantages for investors

Widespread international adoption of IFRSs offers equity investors and debt investors a variety of potential advantages as follows:

1. IFRSs 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”).
3. By eliminating many international differences in accounting standards, and standardizing reporting formats, IFRSs eliminate many of the adjustments analysts historically have made in order to make companies’ financials more comparable internationally. IFRSs adoption therefore could reduce the cost to investors of processing financial information. The gain would be greatest for institutions that create large, standardized-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.

In general, IFRSs offer increased comparability and hence reduced information costs and information risk to investors.

Indirect IFRSs advantages for investors

IFRSs offer several additional, indirect advantages to investors. Because higher information quality should reduce both the risk to all investors from owning shares and the risk to less-informed investors due to adverse selection, in theory it should lead to a reduction in firms’ costs of equity capital. 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. 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. 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.

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 subsidize loss-making activities. Bushman, Piotroski and Smith (2006) report evidence that firms

in countries with timelier financial-statement recognition of losses are less likely to undertake negative-NPV investments. The increased transparency and loss recognition timeliness promised by IFRSs therefore could increase the efficiency of contracting between firms and their managers, reduce agency costs between managers and shareholders, and enhance corporate governance. The potential gain to investors arises from managers acting more in their (i.e., investors') interests. The increased transparency promised by IFRSs 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. 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. 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). However, it is difficult to disentangle the two effects in practice. Recognition timeliness promised by IFRSs 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 IFRSs 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. 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. 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 IFRSs 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. IFRSs 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 IFRSs offer benefits to investors. Over the long term, the indirect advantages of IFRSs to investors could well exceed the direct advantages.

Fair value accounting

A major feature of IFRS standards is the extent to which they are imbued with fair value accounting. Notably:

- IAS 16 and 38 provide a fair value option for property, plant, equipment and intangible assets
- IAS 36 requires asset impairments (and impairment reversals) to fair value less costs to sell and higher of value in use
- 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);
- IAS 40-Investment property is remeasured at fair value which is the amount for which property is exchanged between knowledgeable, willing parties in an arm's length transaction. And after the initial recognition investment property is accounted for in accordance with cost model- cost less accumulated depreciation and less accumulated impairment losses.

- IFRS 2 requires share-based payments (stock, options, etc.) to be accounted at fair value
- IFRS 3 provides for all identifiable net assets to be measured at the acquisition date at fair value.
- IFRS 9 provides for financial instruments to be measured at fair value as mentioned in IAS 39
- IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures and provides a single IFRSs framework for measuring fair value and requires disclosures about fair value measurement.

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

I have distinctly mixed views on fair value accounting. The fundamental case in favor 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
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.

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 thirty 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.

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).

There are many potential problems with fair value in practice, including:

- 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. 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 realizing 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.

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 labeled as such 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 IFRSs 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
- Emphasizes “relevance” relative to “reliability”
- Assumes the sole purpose of financial reporting is direct “decision usefulness”
- Downplays the indirect “stewardship” role of accounting
- 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 concludes (2005):

“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 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 contr. 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 recognized to be useful to equity investors. 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.
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 longstanding property of financial reporting. The other side of “fair value,” timely 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 gain recognition, is not as prevalent in practice. Loss recognition timeliness is particularly evident in common-law countries such as Australia, Canada, U.K. and US. 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 realizable 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 IFRSs 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 hand, 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.

Effect on investors of uneven implementation: I believe there are overwhelming political and economic reasons to expect IFRSs 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 globalization – 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 IFRSs adoption is that investors will be misled 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 IFRSs. 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, IFRSs implementation has not received sufficient attention, perhaps because it lies away from public sight, “under the rug.”

Markets and politics remain primarily local, not global: The fundamental reason for being skeptical 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, 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, IFRSs or no IFRSs. Achieving uniformity in accounting standards seems easy in comparison with achieving uniformity in actual reporting behavior. The latter would require radical change in the underlying economic and political forces that determine actual behavior. Sir David Tweedie, IASB Ex-Chairman, premises the case for international uniformity in accounting standards on global integration of markets:

“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 considering the amount of time the IASB has exerted in lobbying governments (the EU included) on IFRSs 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 increased internationalization 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 internationalization cannot be expected to eliminate diversity in practice.

There is an analogy made between IFRSs and the metric system of uniform weights and measures. 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 practiced 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 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 globalization, it is worth remembering that in fact most markets and most politics are local, not global. 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; 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 industrialized countries (including the US, but not the U.K.) created the International Bureau of Weights and Measures to administer it.
- Politics of government involvement in financial reporting practices (e.g., political influence of managers, corporations, labor 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 labor, 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
- 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 globalization, 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 IFRSs lies at the level of the national standard adoption decision. 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. Episodes like this are bound to occur in the future, whenever reports prepared under IFRSs produce outcomes that adversely affect local interests. Another level at which local political and economic factors are likely to visibly influence IFRSs adoption stems from the latitude IFRSs give to firms to choose among alternative accounting methods. 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 IFRSs 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. Zeff (2006) surveys political influences on standard adoptions in the US, Canada, the UK and Sweden, and also in relation to IFRSs.

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.

Does anyone seriously believe that implementation will be of equal standard in all the nearly 100 countries that have announced adoption of IFRSs 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 IFRSs 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 United Kingdom. It is well known that uniform EU economic rules in general are not implemented evenly, with some countries being notorious standouts. 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 IFRSs? Will auditors, regulators, courts, boards, analysts, rating agencies, the press and other monitors of corporate financial reporting provide the same, for example, *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."

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 IFRSs will only accentuate the extent to which IFRSs implementation depends on manager and auditor judgment, and hence is subject to local political and economic influence. Furthermore, the clear majority of IFRSs adopting countries cannot be said to possess deep securities, derivatives and currency markets. Implementation of the IFRSs 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 meager 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 IFRSs 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, U.K. and US) which have comparatively deep markets and comparatively developed shareholders’ rights, auditing professions, and other monitoring systems. Its philosophy has been tilted by world standards toward a common-law view of financial reporting. 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 recognize economic losses in a timely fashion than financial reporting in Continental Europe and Asia.

Implementation of IAS 36 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 IFRSs adoption that it is in their interests to radically change their behavior. In sum, even a cursory review of the political and economic diversity among IFRSs-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.

Chapter 2

Progressive adoption of the IFRSs in the world with emphasis on EU – mandatory and voluntary adoption

2.1. Beginning of IASs/IFRSs adoption in the world.

IFRSs are example of capital oriented systems of financial reporting rules. The original international standard setter, IASC was formed in 1973, during the period of considerable change in accounting regulation. In US FASB had just been created, in UK first international standard setter had been organized, the EU was working on main plank of its own accounting harmonization plan (the Fourth Directive), and both UN and OECD were shortly to create their own accounting committees. IASC was launched in the wake of 1972 World accounting congress after an informal meeting between representatives of British profession (Institute of chartered accountants in England and Wales) and American profession (American institute of certified public accountants). A rapid set of negotiations resulted in the professional bodies of Canada, New Zealand, Australia, France, Germany, Japan, Mexico and the Netherlands being invited to join to UK and USA in order to form the international body. Due to pressure from UK, the IASC was established in London, where its successor, IASB remains today.

The actual reasons for IASC creation are unclear. A need for a common language was felt, to deal with a growing volume of international business, but other more political motives abounded also. For example some believe that the major motivation was that the British wanted to create an international standard setter to trump the regional initiatives within EU, which leaned heavily to the Code model of reporting, in contrast to what were the norm in UK and almost all English-speaking nations.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977, the IASC had to fight off attempts to become a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

Both UN and OECD were active in international rule making in 1970s, but IASC was successful in persuading them to leave establishment of recognition and measurement rules to IASC. However having established itself as the unique international rule maker, IASC encountered difficulty in persuading any jurisdiction or enforcement agency to use its rules. Although member professional bodies were theoretically committed to pushing for the use of IFRSs at the national level, in practice few national bodies were influential in standard setting in their respective countries(because standards were set by taxation or other governmental bodies) and others (including US and UK) preferred to their national standards to whatever the IASC might propose. In Europe, IFRSs were used by some reporting entities in Italy, Switzerland and national standard setters in some countries such as Malaysia began to use IFRSs as an input to their national rules , while not necessarily adopting them as written by IASC or giving explicit recognition to the fact that IFRSs were being adopted in part as national GAAP.

IASC's efforts entered a new phase in 1987, which led directly to its 2001 reorganization, when then – Secretary General, David Cairns, encouraged by US SEC, negotiated an agreement with the International Organization of Securities Commission(IOSCO). IOSCO was interested in identifying a common international “passport” whereby companies could be accepted for secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company's primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary

listing. IOSCO was prepared to endorse IFRSs as financial reporting basis for this passport, provided that the international standards could be brought up to a quality and comprehensiveness level that IOSCO stipulated.

Historically a major criticism of IFRSs had been that it essentially endorsed all the accounting methods then wide use, effectively becoming a “lowest common denominator” set of standards. The trend in national GAAP had been to narrow the range of acceptable alternatives, although uniformity in accounting had not been anticipated as a near-term result. The IOSCO agreement energized IASC to improve the existing standards by removing the many alternative treatments that were then permitted under standards, thereby improving comparability across reporting entities. The IASC launched its Comparability and Improvements Project with the goal of developing a “core set of standards” that would satisfy IOSCO. These were complete by 1993, not without difficulties and spirited disagreements among the members, but then- to the great frustration of IASC- these were not accepted by IOSCO. Rather than endorsing the standard-setting process of IASC, as was hoped for, IOSCO seemingly wanted to cherry-pick individual standards. Such a process could not realistically result in near-term endorsement of IFRSs for cross-border securities registrations.

Ultimately, the collaboration was relaunched in 1995, with IASC new leadership, and this began as a new period of frenetic activities, where existing standards were again reviewed and revised and the new standards were created to fill perceived gaps in IFRSs. This time the set of standards included, among others, IAS 39, recognition and measurement of financial instruments, which was endorsed, at the very last moment and with great difficulty, as a compromise, purportedly interim standard.

At the time the IASC had undertaken an effort to consider its future structure. In part, this was the result of pressure exerted by US SEC and also by US private sector standard setter, FASB, which were seemingly concerned that IFRSs were not being developed by due process. While the various parties may have had their own agendas, in fact the IFRSs were in need of strengthening, particularly as to reducing the range of diverse but accepted alternatives for similar transactions and events. The challenges presented to IASB ultimately would serve to make IFRSs stronger.

If the IASC was to be the standard setter endorsed by the world’s stock exchange regulators, it would need a structure that reflected that the level of responsibility. The historical Anglo-Saxon standard-setting model- where professional accountants set the rules for themselves- had largely been abandoned in the twenty five years since the IASC was formed, and the standards were mostly being set by dedicated and independent national boards such as FASB, and not by profession-dominated bodies like AICPA. The choice, as restructuring became inevitable, was between a large, representative approach- much like the existing IASC structure, but possibly where the national standard setter appointed representatives- or small, professional body experienced standard setters which worked independently of national interests.

The end of this phase of the international standard setting, and resolution of these issues, came about within a short period in 2000. In May of that year, IOSCO members voted to endorse IASC standards, albeit subject to a number of reservations. This was a considerable step forward for the IASC, which itself was quickly exceeded by an announcement in June 2000 that European Commission intended to adopt IFRSs as requirement for primary listings in all member states. This planned full endorsement by EU eclipsed the lukewarm IOSCO approval, and since then the EU has appeared to be more influential body insofar as gaining acceptance for IFRSs has been concerned. Indeed, the once-important IOSCO endorsement has become of little importance given subsequent developments, including the EU mandate and convergence efforts among several standard setting bodies.

In July 2000, IASC members voted to abandon the organization's former structure, which was based on professional bodies and adopt a new structure: beginning in 2001, standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

2.2. IFRSs – Form, quality and content

The term “IFRSs” is used to refer collectively to the entire body of pronouncements that the companies adhering to the IASB financial reporting framework are required to follow in the preparation and presentation of their general purpose financial statements. These pronouncements consist of IASs promulgated by the IASC and subsequently adopted by the IASB, IFRSs promulgated by the IASB, Interpretations of the Standing Interpretations Committee (SIC) and Interpretations of the IFRIC. IFRSs contain requirements relating to layout and presentation of financial statements, recognition and measurement of financial information, and disclosure of information in general purpose financial statements. IASB standards are principle-based requirements in that they establish broad principles rather than detailed rules. The standards have few ‘bright line’ application rules. The principle-based system ‘requires a clear hierarchy of overarching concepts, principles that reflect the overarching concepts and further limited guidance (ICAS 2006).’ Principle-based standards focus on reporting the economic substance of transactions and their application requires greater use of professional judgment.

Layout and presentation of financial statements is an important issue in financial reporting. It involves consideration of how information should be displayed in the financial statements. The principal IASB accounting standard that deals with layout and presentation of financial statements is revised IAS 1 (IASB 2007). The standard seeks to ensure comparability both with the firm's own financial statements of previous periods and with the financial statements of other enterprises. It requires the financial statements to present fairly the financial position, financial performance and cash flows of the entity. The essence of fair presentation lies in representing faithfully the transactions and events in accordance with their economic reality, and not merely their legal form. It is reasonably assumed that complying with all applicable IFRSs will result in fair presentation.

IFRSs financial statements are prepared on a going concern basis unless management intends to either liquidate the business or discontinue operation. Except for cash flow information, the accrual basis of accounting is followed in the preparation of financial statements. According to IAS 1, a complete set of financial statements includes the following components:

- Statement of financial position
- Statement of comprehensive income
- Statement of changes in equity (SOCE)
- Statement of cash flows for the period

According to the standard, comparative information is to be provided for the previous reporting period. IAS 1 does not prescribe any specific formats for the financial statements but it sets out their minimum contents. There are requirements relating to the information to be displayed on the face of the financial statements.

The statement of the financial position is to present the assets, liabilities and equity of the entity. Certain key items are specified in the standard and it allows the entity to decide on what additional items it should include depending on the nature of the business.

The statement of comprehensive income is to include all non-owner changes in equity. Comprehensive income consists of profit or loss for the period and other comprehensive income, i.e., gains and losses that are not included in profit or loss.

The *statement of changes in equity* is required to present the total comprehensive income for the period, effects of retrospective applications or restatements, and transactions with owners in their capacity as owners (investments by owners and distributions to owners).

The *statement of cash flows* is designed to show the entity's cash flow of the period. It requires details of historical changes in cash and cash equivalents. A distinction is to be made between cash flows from operating, financing and investing activities. The notes summarize the significant accounting policies used by the entity and provide other explanatory details. They are an integral part of the financial statements.

The central focus of IFRSs is on recognition and measurement is related to the elements and their presentation in financial statements. There are requirements relating to recognition and measurement, which prescribe how entities should recognize their transactions and events and how those transactions and events should be quantified in monetary terms. Recognition and measurement are very crucial issues in accounting. This is because they affect the way periodic profits are computed and net asset values are determined. The IASB adheres to a historical cost-dominated mixed-attribute measurement model. However, there are indications that tend to suggest that the IASB is increasingly being inclined to prescribe fair value as the basis of measurement of assets and liabilities. There are provisions for fair value measurement in many of its standards. There are provisions for fair value measurement in respect of financial instruments (IAS 39), investment property (IAS 40), net assets of an acquiree in a business combination (IFRS 3) and biological assets (IAS 41). More recently, the IASB has published IFRS 13 as guidance on how fair value should be measured where it is required by existing standards (IASB 2011).

Disclosure requirements are concerned with the information that an entity is required to provide on a supplementary basis in order to make financial reporting full and fair. There are two types of disclosures: protective disclosures and informative disclosures. Protective disclosures are aimed at protecting users from unfair treatment. The objective of making informative disclosures is to enhance the decision-usefulness quality of information. IFRSs disclosure requirements are focused mainly on the second type of disclosures. The IASB has promulgated some standards that are all about disclosure. Examples include IAS 24, Related Party Disclosures, IFRS 7, Financial Instruments and IFRS 12, Disclosure of Interests in Other Entities. The former standard requires disclosure of information about related party relationships and about transactions and outstanding balances between an entity and its related parties, second one prescribes disclosure requirements that are aimed at enhancing users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows and the latter prescribes a wide range of disclosures about entity's interests in subsidiaries, joint arrangements and associates. The IASB has many recognition-measurement standards that also contain requirements relating to disclosures. In many of its recently promulgated standards, the IASB has placed greater emphasis on disclosures.

Historically, legal systems, combined with other political and economic differences, created a vast diversity of accounting systems, which makes meaningful comparison of financial reports across borders difficult. Europe is the origin of many legal systems: English, German, French and Scandinavian, and thus, prior to harmonization, there were extremely diverse, country-specific accounting systems. Recognizing this, members of the EU were the first countries to move toward harmonization of accounting standards.

In the late 70s and 80s, the European Union issued several directives to harmonize financial reporting practices to reduce diversity and facilitate cross-listings and cross-border investment. Accounting harmonization progressed in the 1990s with the improvement of IASs (the precursor of IFRSs), harmonization events in the EU economy (e.g., adoption of a single currency), and political changes (e.g., disappearance of border control within the Schengen area). Although IFRSs adoption was not mandatory until 2005, in the late 1990's, firms in some European

countries were allowed to use IASs as a substitute for domestic accounting standards. In this section, I trace the history of harmonization and then describe research associated with its different stages. This presents a clear picture of historical differences between national accounting standards in the EU relative to IFRSs, as well as an understanding of the economic consequences of past accounting harmonization. Results from past literature can provide insights about the effects of mandatory IFRSs adoption.

Historically, the European Commission's (EC) directives were aimed at making financial statements increasingly comparable in terms of format and general recording and measurement rules. The Fourth Directive, enacted in 1978, and the Seventh Directive, enacted in 1983, were the most influential directives during the early stages of financial reporting convergence within the EU. The Fourth Directive specifies "True and Fair View" (TFV) as an overriding principle of financial reporting, and defines the format and measurement of balance sheets and income statements. TFV is a broad concept in which accounts are reported with the aim of providing unbiased information about activities that affect a company's intrinsic value (Ekholm and Troberg 1998). The Seventh Directive addresses issues associated with consolidations. It sets forth requirements for consolidation and applies TFV to consolidated financial statements.

The most important effects of both directives are the adoption of TFV and relaxation of book-tax conformity for consolidated accounts (Joos and Lang, 1994). Although parent company financial statements can still follow tax returns, consolidated financial statements must adopt TFV, where measures that are tax-driven but do not reflect underlying economic activities are disallowed. As an exception, the German Accounting Directives Law of 1985 expressly allowed tax-based accounting even when it was inconsistent with TFV (Harris et al., 1994).

The effectiveness of the directives is a source of debate within both industry and academic level. The most prominent argument concerns appropriateness of TFV. TFV is an accounting principle that stems from accounting practice in the U.K. The intent of adopting TFV was to make accounting information more value relevant and more useful in providing information to determine stock prices. However, there are many other users of financial statements who have less of a demand for TFV. Governments demand tax information from companies, debt holders demand information about companies' ability to service their debt, and labor unions require information to negotiate labor contracts. Forces of informational demands from different contracting parties influence the outcome of financial reports. This is particularly evident in countries such as Germany and France, where TFV had not been previously adopted. Financial reports in these countries primarily reflected the needs of governmental entities for tax compliance, rather than provision of information for investors. In addition, interpretation of TFV in the U.K. has evolved over time. It may take time before all EU countries share similar interpretations of the basic principle.

Joos and Lang (1994) provide one of the first empirical investigations of the effect of the two directives. They compare firms in the U.K. and Germany. The objective of the U.K. accounting model is to provide useful information to shareholders, with a role that is distinct from tax reporting. The German model focuses on debtholders and serves both financial and tax reporting systems. U.K. and Germany thus represent two extremes of accounting systems in Europe in existence at the time of the study. Joos and Lang (1994) argue that because of their focus, earnings of firms in the U.K. should better reflect underlying economic results and have higher correlation with stock prices than earnings of German firms. German accounting systems tend to report low earnings and shareholder's equity to satisfy the conservative nature of bank lending policies. They find that German firms have lower ROE, E/P, and book-to market ratios relative to U.K. firms. However, they do not find that earnings explain stock prices and returns more in the U.K. than in Germany. They also fail to find evidence of convergence in ROE, E/P, and book-to-market ratio after implementation of the directives, and thus conclude that the directives

may have provided more form than substance because of the differences in the incentives of financial reporting across countries.

Harris (1994) performs a similar test, comparing the value relevance of German GAAP with US GAAP before and after the effective date of the two directives. Their regression of returns on earnings and changes in earnings, deflated by beginning market value, shows no difference in explanatory power between German and US GAAP earnings, both before and after the two directives. In contrast, the regression of price on earnings and book values of equity shows a higher R-squared for US samples. In addition, the explanatory power for German firms does not increase after the new law. Harris (1994) also compares the value relevance of reported earnings with Deutsche Vereinigung für Finanzanalyse und Anlagenberatung (DVFA) earnings. DVFA is the German financial analyst society, which developed a metric to adjust reported earnings to “permanent earnings.” They find limited evidence that using DVFA earnings increases R-squared. Consistent with Joos and Lang’s (1994) findings on low book value of equity and earnings in Germany, regression coefficients on earnings and book values of equity in Harris (1994) are higher for German firms.

Auer (1996) tests the informativeness of earnings announcements for a sample of Swiss firms that changed their accounting standards from the Swiss GAAP to either IASs or EC Directive-compliant accounting standards. He does not find significant increases in abnormal returns around earnings announcement dates before and after firms change to IASs or EC Directives and between IASs and EC Directives firms after the change. Auer (1996) does, however, find a significant increase in the variance of abnormal returns for firms changing to IASs. He concludes that earnings under IASs have more information content than earnings based on Swiss GAAP, but not more than earnings based on EC Directives. However, his mixed results may reflect issues arising from a small sample size (35 companies) and lack of controls for self-selection. The results indicate that IASs firms are much larger in market value and have higher interim reporting frequency than EC Directives firms. IASs firms may also have a higher analyst following (Ashbaugh and Pincus, 2001), which may result in greater availability of firm-specific information before earnings announcements and thus a reduction in the unexpected information content of released earnings.

In summary, although the purpose of EC directives is to unify the conceptual framework of financial reporting in the EU, research results regarding the success in achieving this goal are mixed. Nevertheless, EC directives are the first step towards accounting harmonization and provide useful insights into the difficulties of the project. They also result in a unified format of financial statements that facilitate cross-border research.

2.3. The overview of IASB

The IASB is a London based independent, full time accounting standard-setting body of the IASC Foundation. It is funded by contributions from major accounting firms, financial institutions and industrial companies throughout the world: central and development banks; and other international and professional organizations. Its members are chosen for their expertise in accounting. The IASB was originally formed in 1973 as the International Accounting Standards Committee (IASC) to develop quality accounting standards and to promote their worldwide acceptance and observance. It had been in operation for nearly three decades, during which period it had developed 41 accounting standards covering a wide range of financial accounting and reporting topics. During this period, the IASC had also developed a conceptual framework, *Framework for the Preparation and Presentation of Financial Statements*, which states the basic principles for accounting standards. In 2000, the IASC members voted a new IASC Constitution, giving effect to a major restructuring. The new constitution came into effect in April 2001 when

the IASB replaced the IASC. The restructuring has allowed the body to strengthen its position as a global accounting standard setter.

The reconstituted standard-setting body consists of 16 members. To achieve a balance of perspectives and experience, a minimum of five members of the IASB are selected from persons having audit backgrounds, a minimum of three with experience in financial statements, a minimum of three from among the users of financial statements, and at least one with an academic background. The members are responsible for preparing exposure drafts, revising old standards and announcing new ones. As the IASB aims at bringing about changes in national standards, it establishes contacts with national standard setters through a liaison person in the Board. The new constitution requires that seven IASB members have formal liaison responsibility with national standard setters in Australia–New Zealand, Canada, France, Germany, Japan, UK and the USA. Regular joint meetings of the chairs of those standard setters and the IASB are held to assess current situations.

The IASB adopted all the IASC standards that were in force at the time it began its operations. These pronouncements continue to be designated as ‘International Accounting Standards (IASs)’. The new standards being developed by the newly constituted body are designated as ‘International Financial Reporting Standards (IFRSs)’. The IASB has also retained the conceptual framework developed by its predecessor body. But the document is now being reformatted in order to enhance its usefulness.

The IASB has an interpretative body known as ‘International Financial Reporting Interpretations Committee (IFRIC)’, which is designed to help the IASB improve financial reporting through timely identification, discussion and resolution of financial reporting issues within the framework of IFRSs. It develops authoritative interpretations of existing standards which are referred to the IASB for discussion and approval. If the interpretations are approved, they become part of IFRSs. Complying with the interpretations is obligatory on the part of companies reporting under IFRSs.

The IASB publishes its pronouncements in English, which is its official language. The pronouncements are translated into other languages for use in countries where English is not in use. There is in place a well-organized and rigorous system of translating the pronouncements. Currently, the translated versions of IFRSs are available in about 40 languages. Although sufficient care is taken to prevent distortions, translation problems persist. This is because, certain English words, phrases, and terms cannot be translated into other languages.

The IASB is considered to be a well-equipped standard-setting body having the ability to develop high-quality accounting standards. It meets all the characteristics of a high-quality standard setter as outlined in the US SEC *Concepts Release*. These characteristics include:

- An independent decision-making body
- An active advisory function
- A sound due process
- An effective interpretative function
- Independent oversight representing the public interest
- Adequate funding and staffing

The IASB works in a very transparent manner. It follows an international due process in setting its standards. The process is elaborate, and it involves accountants, financial statement users, the business community, market regulators, academics, and other interested individuals and agencies from around the world. The IASB *Due Process Handbook* (IASB Foundation 2006) provides a detailed description of the consultative arrangements followed in developing accounting standards. There are several stages in the due process of setting standards. They include preparation of discussion documents, publication of exposure drafts and final issuance of standards. The process does not come to an end with the promulgation of standards. The IASB

holds regular meetings with interested parties to assess the unanticipated issues arising from implementation of the standard.

The IASB is currently enjoying a strong global support. Its mission of making one global accounting framework a practical reality has been supported by many worldwide organizations and agencies, including the United Nations (UN), the World Bank, the Organization for Economic Co-operation and Development (OECD), the World Trade Organization (WTO), the European Union (EU), the International Organization of Securities Commission (IOSCO) and the International Forum on Accountancy Development (IFAD). Most of these organizations have taken active interest in promoting measures for facilitating the process of adoption of IFRSs.

A major problem with the IASB is that it has no enforcement authority. Since it is a private sector body, it cannot compel countries to comply with its standards. For achieving compliance, the IASB has to depend on the follow-through of the accounting regulators in individual countries.

2.4. Voluntary adoption of IASs in the 1990s

Voluntary adoption of IASs accelerated in the late 1990s. Firms in need of foreign equity investment had to make listing decisions based on the characteristics of the exchange such as liquidity and trading values as well as the accounting standards that are required in that exchange. More firms started to choose IASs as stock exchanges in Europe became more favorably disposed toward IAS. Germany's New Market, the European equivalent of the US NASDAQ, was launched in 1997 to aid small hi-tech companies in raising equity. All companies listed on the New Market were required to use either US GAAP or IASs.

Another important reason for the surge in voluntary IASs adoption was that IASs became much improved. In 1987, in response to criticism of too much leeway for non-compliance and too many opportunities for earnings management under IASs, IASC initiated a major effort to constrain accounting choice. The Comparability and Improvements Project was completed in 1993, with a result of 10 new standards.

Furthermore, a new set of core IASs was completed in 1998, which required firms claiming IASs compliance to comply fully with the standards (instead of only partial compliance required prior to 1998). The core standards received conditional endorsement from the International Organization of Securities Commission. During this period, several countries, including Austria, Belgium, France, Germany, Italy, and Switzerland allowed firms voluntarily choose IASs instead of their domestic GAAP.

2.4.1. Properties of IASs versus other national standards

German firms are the most frequently used comparison in studies of IASs. Unlike IASs' focus on shareholders, German GAAP has traditionally focused on stakeholders and uses the "prudent" approach in financial reporting. Germany also has a strong legal system in terms of rule of law and efficiency of the judicial system to ensure compliance with the chosen accounting standards. The large differences between two accounting standards and the high compliance levels likely increase the power of empirical tests using German samples.

German firms adopting IASs must reconcile one-year-before German GAAP financial statements to IASs. This provides a good setting for comparison because both German GAAP and IASs numbers are available for the same period. Hung and Subramanyam (2007) find several major differences between IASs and German GAAP using same period financial statements. First, IASs eliminates book-tax conformity. For example, depreciation expenses must be determined by commercial substance instead of tax laws. Elimination of book-tax conformity

thus increases deferred tax and changes depreciation expenses on income statements and accumulated depreciation on balance sheets. Second, asset re-valuation and fair value reporting under IASs also increases the value of PPE, inventory, receivables, financial instruments, and intangibles. Goodwill under IASs is capitalized and amortized unlike the direct offset against shareholders' equity under German GAAP. Thus, IASs adoption increases net income and book value of equity. Third, both standards have similar revenue recognition rules and create comparable sales amounts. Fourth, German GAAP allows frequent use of loss provisions and earnings smoothing and thus results in less volatile net incomes.

Hung and Subramanyam (2007) compare the value relevance of the two accounting standards by regressing stock prices on book values and net incomes. Their study finds that although differences in R-squared under the two standards are not significant, book values of equity have a higher coefficient under IASs and net incomes have a higher coefficient under German GAAP.

The low correlation between IASs earnings and stock prices does not mean that IASs earnings are less efficient for contracting and monitoring, however. For example, large one-time charges tend to reduce the correlation between earnings and stock returns (Basu, 1997 and Hayn, 1995), but may motivate managers to withdraw investment from loss projects (Bushman et al., 2006), thus increasing the efficiency of monitoring by shareholders and debt-holders.

Bartov (2005) compares the value relevance of German GAAP, IASs, and US GAAP for firms traded on German stock exchanges. Defining value relevance as the coefficient of the regression of return on earnings deflated by beginning market value, they find a higher coefficient on IASs and US GAAP earnings than German GAAP earnings, but no difference between IASs and US GAAP. The difference in coefficients is an inappropriate test for relative value relevance, however. Tests of relative value relevance such as between two exclusive accounting standards should be tested by the difference in R-squared (Biddle et al., 1995). The coefficient on earnings should be interpreted as the capitalization of earnings. The difference in the coefficient could be caused either by the difference in the growth rate between German, IASs, and US GAAP samples, level of conservatism, or by noise in measurement of earnings, which is the dependent variable.

The findings in Bartov (2005) are inconsistent with those of Hung and Subramanyam (2007), in which German earnings have a higher coefficient in a regression of price on book value and earnings. This inconsistency could be caused by omission of the book value of equity in the regression model employed by Bartov (2005). Book value could be an omitted variable that is correlated with earnings in the regression of return/price on earnings, thus biasing the coefficient on earnings. These inconsistent results could also arise from the use of two different samples; Whereas the sample in Hung and Subramanyam (2007) is limited to firms that changed accounting standards to IASs, with the availability of financial statements one year before the IASs adoption (when both IASs and German GAAP financial statements were available), the sample in Bartov (2005) is larger and includes all firms traded at German stock exchanges from 1990 to 2000.

Harris and Muller (1999) examine whether reconciliation items explain stock prices and returns. Their sample consists of firms that reconcile IASs earnings and book values of equity to US GAAP using Form-20F. Their results are mixed and depend on the regression model specification. They find that differences in earnings and book values of equity are insignificant between IASs and US-GAAP and much smaller than differences between US GAAP and other accounting standards. They argue that this result is consistent with the results of Harris (1995), who finds that IASs measures are similar to US GAAP. However, the sample in Harris and Muller (1999) biases against finding any significant differences between IASs and US GAAP because IASs firms listed in the US are more likely to choose accounting methods consistent with US GAAP without violating IASs (Pownall and Schipper, 1999; Ashbaugh and Olsson, 2002).

In summary, research on the comparison among home country accounting standards in the EU, US GAAP, and IASs provide mixed results. In addition to sample selection biases, there are methodological issues that may reduce test power in this type of research. I will talk about the methodological issues in following sections. .

2.4.2. Economic consequences of voluntary IASs adoption

Adopting IASs appears to reduce information asymmetry between managers and shareholders. Prior literature finds a reduction of information asymmetry as evidenced by lower earnings management, lower costs of capital, and lower forecast errors. I will examine each of these economic consequences below.

Barth (2006) suggest that accounting quality could be improved with elimination of alternative accounting methods that are less reflective of firms' performance and are used by managers to manage earnings. They compare earnings management for firms that voluntarily switch to IASs with firms that use domestic accounting standards. They find that after IASs adoption, firms have higher variance of changes in net income, a higher ratio of variance of changes in net income to variance of changes in cash flows, higher correlation between accruals and cash flows, lower frequency of small positive net income, and higher frequency of large losses. Barth (2006) also investigates the value relevance of earnings by comparing the R-squared from two regressions: 1) price regressed on book value and earnings; and 2) earnings regressed on positive and negative returns. They find that R-squared increases after IASs adoption, providing evidence of greater value relevance for IASs earnings.

Van Tendeloo and Vanstraelen (2005) examine discretionary accruals of German firms adopting IASs. Contrary to Barth (2006) they find that IASs firms have more discretionary accruals and a lower correlation between accruals and cash flows. However, their use of the Jones (1991) model in this setting may lead to measurement errors for discretionary accruals. The Jones model requires fixed assets for measurement of non-discretionary accruals. If fixed assets are revalued under IASs, non-discretionary accruals as a predicted value from revenue and fixed assets may contain errors. Intuitively, if out-of-sample revalued fixed assets are plugged in to get non-discretionary accruals, this will reduce the amount of discretionary accruals, but the effect on the absolute amount of discretionary accruals is unknown. If future depreciation expense is based on the revalued amount, asset revaluation will also change future total accruals through a higher depreciation expense. However, the change in accruals attributable to asset revaluation may be value relevant. Aboody (1999) find that upward revaluation of fixed assets by U.K. firms is positively related to future operating income and cash flow from operations. Therefore, the empirical tests of van Tendello and Vanstraelen (2005) should be interpreted with caution. Future research using the Jones model should adjust for asset revaluation.

Leuz and Verrecchia (2000) investigate the impact of changing accounting standards on the cost of capital by using bid-ask spreads and stock turnover ratios as proxies for the cost of capital. They suggest that opaque information environments reduce the demand for stocks and thus increase bid-ask spreads and lower stock turnover ratios. To attract potential investors, firms with low financial reporting quality have to issue stocks at a discount and hence at higher costs of capital (Diamond and Verrecchia, 1991). Bid-ask spreads and turnover ratios are therefore good proxies for the cost of capital. Leuz and Verrecchia (2000) contend that switching from German GAAP to IASs or US GAAP represents a substantial increase in firms' commitment to greater disclosure. A commitment to disclosure is a decision by a firm to disclose before it knows the content of the information. This commitment should have a stronger economic consequence than voluntary disclosure, which is a decision to disclose after the firm knows the content of the information and can be reversed in the future. After controlling for self-selection bias, Leuz and Verrecchia find that firms voluntarily adopting IASs or US GAAP have lower

bid-ask spreads and higher stock turnover ratios, but the difference between IASs and US GAAP firms is not statistically significant. In contrast, Daske (2006) fails to find a decrease in the cost of equity, measured from several stock valuation models for German firms adopting IASs or US GAAP.

Leuz (2003) examines bid-ask spreads and stock turnover ratios for US GAAP and IASs firms in Germany's New Market, where US GAAP and IASs are the only allowed financial reporting standards. Consistent with Leuz and Verrecchia (2000), he does not find any statistical differences in bid-ask spreads and turnover ratios across the two standards. Ashbaugh and Pincus (2001) investigate whether analyst forecast errors decrease after a firm adopts IASs. They argue that IASs adoption reduces analysts' cost of information acquisition and improves forecast accuracy, even though earnings smoothing under other accounting standards makes forecasts easier. They find that forecast errors are positively related to the difference between a country's domestic accounting standards and IASs. After IASs adoption, forecast errors decrease and the number of news reports about sample firm increase.

Cujipers and Buijink (2005) examine recent and early adopters of IASs or US GAAP. They suggest that analysts need time to understand financial statements under the new standards. They find that recent adopters have higher forecast dispersion and lower analyst following than early adopters. These results suggest that realization of the benefit of switching to non-local GAAP may take time.

2.4.3. Mandatory adoption of IFRSs in the EU

On June 6, 2002, the Council of Ministers of the EU issued an official statement to require all listed companies in the EU to use IFRSs in their consolidated or simple accounts for the fiscal year starting January 1st, 2005. Several studies examine the economic consequences of announcements and other events leading up or subsequent to these announcements. Comprich (2003) identifies 11 dates between 2000 and 2002 that signal the likelihood or the timing of IFRSs adoption in the EU. They find stock market reacted positively to news that increases the likelihood of IFRSs adoption.

Armstrong identifies 16 events between 2002 and 2005 that may change the likelihood of the adoption of IFRSs and the controversial fair value accounting on financial instruments, IAS 39. They find that stock market reaction is significantly positive (negative) in reaction to the events that increased (decreased) the likelihood of the adoption and the reaction is stronger for firms that do not cross-list in the US. They conclude that equity investors perceive the benefit of the harmonization, but the benefits are expected to be smaller for firms cross-listing in the US, since US GAAP is closer to IFRSs than were most European domestic GAAPs.

In contrast to the 3-day short-window test in Armstrong et al., Pae focuses on the reduction of Tobin's Q associated with high agency costs in a long-window test over the period when the EU moves to IFRSs. They examine differences stemming from the concentration of control (e.g., family or dispersed ownership) and the impact of the divergence between cash flow rights and control rights for related entities. They find that from 1999 to 2003, Tobin's Q increased more for EU firms that: 1) were not listed in the US; 2) were family-controlled; and 3) had low analyst following. Pae (2006) attributes their findings to the announcement of IFRSs adoption in the EU, which leads to expectations of reduced future agency costs.

Barth analytically examines price informativeness after harmonization of accounting standards and finds that changes in price informativeness can result from two effects.

First, there is a direct informational effect, which is the change in measurement error under the new standards.

A second, indirect, effect is the change in the amount of information from experts that is incorporated into stock prices. This change is determined by the cost and benefit of information acquisition. For example, if measurement error is decreased by new standards, both the benefit and cost of expertise acquisition are reduced. The net impact on price of information from experts will thus depend on the new, relative cost and benefit of expertise acquisition. The direct and indirect effects may have opposite impacts on price informativeness.

Although measurement error decreases, price informativeness may not increase. This is because the amount of information acquired by experts may decrease as a result of a relative reduction in benefits of information acquisition. Barth explores several conditions affecting the direction of the change in price informativeness.

Barth also suggests that the cost for a country's investors to become accounting experts for another country is reduced when the GAAP for the two countries become closer to each other. This increase in expertise results in an increase in stock price informativeness in the second country, because there are more investors who are experts in interpreting that country's financial information. Once sufficient time has passed following mandatory adoption of IFRSs in the EU, this analytical result could be tested empirically.

Research could investigate whether the price informativeness of the US stock market changes after EU countries adopt IFRSs, which is supposedly more similar to the US GAAP than were the country-specific GAAPs.

Another way that adopting IFRSs can improve earnings quality is through monitoring by investors. Adopting IFRSs in EU countries reduces the cost of comparing firms across borders. It also reduces the investor cost to evaluate the quality of financial reports between two firms. The ease of comparison puts pressure on managers to reduce earnings management. To date there is no direct empirical test of this argument.

Following Basu, studies have emphasized the importance of conservatism as an important metric of accounting quality within an international setting. Basu interprets accounting conservatism as accountants' tendency to require a higher degree of verification when recognizing good news over bad news. This is also termed 'asymmetric timeliness of earnings' or 'timely loss recognition' in the sense that economic losses are more quickly recognized in accounting earnings than are economic gains. Watts argues that conservatism is an important feature of financial reporting in ensuring efficient contracting between shareholders and debt holders and between shareholders and managers by limiting managerial bias and the risk of opportunistic payments (e.g., compensation, dividends); in reducing the risk of litigation; in reducing the present value of taxes and in reducing the political costs to regulators of firms overstating net assets. Kothari further argues that the demand for credible financial information from shareholders and debt holders leads to conservatism.

Francis and Dechow consider timely loss recognition as an important attribute of earnings quality. Nevertheless, as noted by Holthausen, many forces shape the quality of financial reporting and accounting standards are only one of them. Country specific reporting incentives affect the quality of financial statement information and accounting standards alone cannot always mitigate these differences. The focus on standards alone may be incomplete because financial reporting practice is sensitive to the incentives driving managers and auditors, which themselves are a consequence of market and political forces.

I examine the impact of the mandatory change to IFRSs by European firms on the level of accounting conservatism and check whether well documented differences in conservatism across countries and varied institutional and legal settings survive the change. The 2005 mandatory IFRSs adoption for all listed European companies creates an ideal setting for testable hypotheses concerning the interaction between accounting standards, institutional settings and timely loss recognition. Following Watts' call for more time-series studies on the effect of GAAP changes

on conservatism, I examine pre and post conditional conservatism for the sample of European firms adopting IFRSs in 2005, over 2003 to 2007 and covering 16 countries (Austria, Belgium, Denmark, Germany, Finland, France, Great Britain, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, and Switzerland). I use the empirical approach first suggested by Basu and subsequently used in numerous studies (Pope and Walker 1999, Ball 2000, Ball 2003).

First, I confirm results in prior research that pre-IFRSs there existed significant differences in conditional conservatism across European countries and across various legal and institutional regimes. I show that countries with higher governance, countries with more significant debt markets and countries with less concentrated ownership and stronger enforcement had greater conditional conservatism. Second, I think that accounting conservatism has decreased after the adoption of IFRSs overall and in many countries (France, Germany, Netherlands, Portugal, and Switzerland). Conservatism has also decreased across code law countries; French and German law origin countries; countries with higher perceived levels of governance, shareholder protection and governance; and countries with important debt markets and less developed equity markets. I also find a reduction in conservatism in countries where the tax book conformity was high. Third and more importantly, I conclude that differences across countries, institutional and legal settings disappear after mandatory IFRSs adoption. The level of conservatism post-IFRSs is now not significantly different across the vast majority of EU countries (with the exception of Italy and Switzerland being less conservative), across legal origins or traditions, across governance, investor protection, and public enforcement regimes, across debt-based or equity-based economies or across more different tax-book conformity regimes. I only find weak evidence that insider economies with weak enforcement (Greece, Italy, Portugal, and Spain) continue to have a lower level of conservatism. I contribute to the current debate on accounting changes and financial reporting quality. Whereas legal incentives, financial systems and accounting traditions prior to IFRSs lead to varying levels of conservatism, the mandatory IFRSs adoption has reduced conservatism and more so, differences in the level of conditional conservatism across European listed firms.

Conservatism in accounting

Dickhaut and Littleton suggest that conservatism has been around since the 15th century, pre-dating Pacioli's treatise on accounting bookkeeping. They argue that, by limiting the overstatement of net assets and income, conservatism constrains actions that could harm one's reputation in a multi-period world of exchanges based on reciprocity. Watts offers four explanations for the demand for conservatism: contracting, shareholder litigation, taxation and regulation. For one, conservatism is an efficient contracting mechanism since it limits managerial opportunism and counters managerial bias which is beneficial to firm value since it constrains opportunistic payments to management itself (compensation) or other parties such as shareholders (dividends). Further, conservatism can limit litigation costs which are more likely when overstating a firm's net assets and can reduce the present value of a firm's taxes. Finally, conservatism can reduce the political costs to standard setters and regulators from criticism if firms overstate net assets. Up to recently, the IASB's conceptual frameworks had a place for conservatism or prudence, a dimension of comparability, verifiability, timeliness and understandability are considered qualitative characteristics of financial statements. IASB's *Framework for the Preparation and Faithfull Presentation of Financial Statements* [(2010) states:

"Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated".

To the surprise of many, the new joint conceptual framework of the IASB and FASB adopted in September 2010 but on the table now for almost a decade does not include conservatism or prudence as a desirable quality of financial reporting information and considers “faithful representation” as a fundamental quality characteristic of financial information which implies a focus on completeness, neutrality, and freedom from errors and bias. IFRSs are more principle based than rule based. Examples of IFRSs neutrality include greater use of fair values, impairment testing rather than amortization including the possibility to reverse prior impairments and clearer rules on how and when to book provisions (IAS 37 is said by many to curtail ‘cookie jar reserves or provisions’ quite prevalent in Continental Europe).

Literature review

While Watts surveys differences in conservatism in the US, I focus on time series and across country differences in Europe. Ball examines the effects of international institutional factors on the properties of accounting earnings. He finds that accounting income in common-law countries (US, UK, Australia, Canada) is significantly more timely than in code-law countries (France, Germany, Japan) during the 1985-1995 period, due entirely to quicker incorporation of economic losses (income conservatism). Ball suggests that UK income is less conservative than other common-law countries, Pope and Walker analyze differences in the timeliness of income recognition between the US and UK during the 1979-1996 period and conclude that apparent differences in conservatism between the US and UK are sensitive to the inclusion or exclusion of extraordinary items in UK. Since under UK GAAP there is greater latitude in the accounting for extraordinary items, their results suggest that UK firms recognize bad news faster than US firms but that they classify the bad news differently.

Giner and Rees looking at sample years 1990-1998 find weak evidence that asymmetric recognition is stronger in the UK (common law) than in France (code-civil law) or Germany (code law). Raonic further examines a sample of European firms from 1987-1999. They conclude that conservatism and timeliness are present and increasing regardless of the legal tradition while the importance of the equity markets jointly with the level of enforcement can explain some differences. Bushman and Piotroski examine the joint impact of legal system, securities law, political economy and tax regime.

Ball (2003) examines East-Asian countries and Ball (2000) examines an international setting asymmetric timeliness in 38 countries over the period of 1992 to 2001. They find greater conservatism in countries with high quality judicial systems after controlling for legal origin. Moreover, they find a similar result for countries with strong public enforcement from securities law but no impact from private enforcement aspects. They also show that managers adjust their financial reporting to the level of involvement of the state. Common law countries with low state involvement and civil law countries with greater state involvement exhibit greater conservatism. However, they find mixed and inconclusive results as to the impact of financial architecture and tax regime. Bushman (2011) examines the impact of country specific conditional conservatism on capital allocation and finds that investment responses to declining opportunities increase with conservatism, but not for increasing investment opportunities. Gassen (2006) examines 23 developed equity markets over the 1990-2003 period and show that cross-country differences in conditional conservatism are influenced by the effects of other accounting properties, mostly income smoothing and to a lesser extent unconditional conservatism. Gaio (2010) examines the relative importance of firm, industry and country characteristics in 38 countries over a similar time window ranging from 1990- 2003 in explaining aggregate earnings quality based on many attributes including conservatism.

None of the above studies covers the most interesting period following the mandatory adoption of IFRSs by European countries in 2005. While there have been numerous country specific and

cross-country studies on the impact of mandatory IFRSs adoption on various dimensions of earnings quality such as value relevance or earnings management and potential consequences, for example on the cost of equity.

Ahmed (2010) examines both European and non-European countries (Australia, Hong Kong, Philippines and South Africa). He finds a reduction in the timeliness of loss recognition after 2005, being more pronounced in countries with strong rule of law. Another concurrent paper examines accounting conservatism within Europe. Piot (2010) contrasts conditional and unconditional conservatism around the IFRSs voluntary and mandatory adoption and the role of Big 4 auditors more specifically. Relative to the studies mentioned above, my focus is more specifically on European 2005 mandatory IFRSs adopters and on country specific results. While my findings are consistent with the above cited materials (all materials report a decrease in accounting conservatism following the IFRSs adoption), I contribute to the literature by explaining this decrease of accounting conservatism with legal incentives, corporate governance mechanisms, enforcement structure of the financial system, prior accounting traditions and tax book conformity.

Legal incentives: Ball (2000) and Leuz (2003) argue that legal differences can have an impact on the characteristics of financial reporting information. Ball (2000) suggests that the stakeholder focus in code law countries leads to greater politization and demand for income to determine the payout to labor, capital and government. This leads to a desire for less volatility and therefore more discretion than in the shareholder focused common law countries. It is documented that earnings management is more frequent in code law countries (especially of French and German law origin) than in common law countries (Leuz 2003). Ball also argues that the presence of other stakeholders in the governance structures reduces information asymmetry between parties further reducing the demand for conservatism. While Ball (2000) does find support for this view, other papers looking at European firms in particular have found replicating these results difficult. As pointed out by Giner and Rees (2001), on other measures of conservatism (lower earnings or equity to some benchmark), German law origin countries are more conservative than French ones, both more conservative to English law origin countries.

One can also argue that countries where income distribution is more politized would prefer being conservative to limit distribution to other stakeholders. Leuz uses two classification schemes for law regimes. The first is legal tradition which is broken down in two groups: common law (Great Britain and Ireland) vs. code law (all other European countries). The second is four different legal origins: English (Great Britain and Ireland); French (Belgium, France, Greece, Italy, Netherlands, Portugal, and Spain); German (Austria, Germany, and Switzerland) and Scandinavian (Denmark, Finland, Norway, and Sweden).

Governance, investor protection and enforcement: Bushman and Piotroski argue that strong investor protection, a solid system of legal enforcement and strong corporate governance mechanisms increase the demand by shareholders for verifiable financial information and the ability to engage in successful litigation. In turn, this should lead to more conservative accounting. To examine specifically governance and enforcement, Bushman and Piotroski use three different indexes. One corporate governance classification scheme is from Aggarwal (2009). *GOV44* is based on 44 frequently studied attributes measured by the Institutional Shareholder Services (ISS), a comprehensive inventory of governance attributes of US and foreign firms. These include attributes from four broad categories:

1. Board (25 attributes)
2. Audit (3 attributes)
3. Anti-takeover provisions (6 attributes)
4. Compensation and ownership (10 attributes)

Board attributes capture the aspects of the board of directors such as board independence, composition of committees, size, transparency, and how the board conducts its work. Audit includes questions on the independence of the audit committee and the role of auditors. Anti-takeover provisions are drawn from the firm's charter and by-laws and refer to dual-class structure, role of shareholders, poison pills, and blank check preferred. Compensation and ownership deals with executive and director compensation on issues related to options, stock ownership and loans, and how compensation is set and monitored. The average presence of these 44 attributes across this sample is 0.48. Low governance countries (below the mean) include Austria, Belgium, Denmark, France, Greece, Italy, Norway, Portugal, and Spain.

A second governance index is taken from La Porta (1998) and measures outside investor rights (actually called the anti-director rights index, *ANTIDIR*). The index ranges from 0 (low outside shareholder rights) to 5 (high). The average level for this sample is 2.56. Low outside shareholder rights countries includes Austria, Belgium, Denmark, Germany, Greece, Italy, Netherlands, and Switzerland.

The index of public enforcement equals the arithmetic mean of (1) supervisor characteristics index; (2) rule-making power index; (3) investigative powers index; (4) orders index; and (5) criminal index. The average for my sample is 0.35 with below average countries including Austria, Belgium, Denmark, Finland, Germany, Greece, Ireland, Norway, Spain, and Switzerland.

The Relative importance of equity markets and debt markets: It has become traditional to oppose equity markets to debt markets. Ball (2000, 2003) argues that in equity markets the demand for accounting quality is driven by a large number of stockholders. Inversely, in debt markets, the demand for high-quality accounting data is lower because information asymmetry is more likely to be resolved through insider communications with management. This view is supported by Ali and Hwang (2000) who finds that firms from countries with debt-oriented (as opposed to equity-oriented) financial systems exhibit lower value relevance of accounting data. More recently, Ball (2008) formulates the opposite hypothesis arguing that financial reporting quality (i.e. conservatism) is shaped by the debt rather than the equity market. From this costly contracting perspective, financial reporting affects various balance sheet and earnings-based financial ratios used in debt covenants to impose restrictions on leverage, dividends, stock repurchases, risky new investments and acquisitions. Using a cross country research design, the results reported by Ball (2008) are consistent with the hypothesis that timely loss recognition is associated with debt market size but not with equity market size. Peek (2010) also shows that creditor but not investor reporting demands explain the public versus private firm difference in asymmetric timeliness. Investors do demand more symmetric timeliness to facilitate contracting and communication with firms as they get further removed from management. The results of Ball (2008) suggest that conservatism is driven by debt markets, and not by equity markets. Given the strong focus of the IFRSs standards on equity markets and towards shareholders as the main users of financial statements, we could expect a greater decrease in debt market dominated countries unless the pressure from these forces dominates the introduction of more neutral IFRSs.

Combining legal, governance, enforcement and market type: Leuz (2003) performs a cluster analysis which groups countries based on similar legal and institutional characteristics into three groups: group #1 includes countries with outsider economies and large stock markets, dispersed ownership and strong investor rights and legal enforcement (Great Britain and Norway); group #2 has insider economies and less developed stock markets, concentrated ownership, weak investor rights but strong enforcement (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Netherlands, Sweden, and Switzerland); group #3 consists of insider economies with weak enforcement (Greece, Italy, Portugal, and Spain).

Beyond the discussions above, Bona-Sanchez (2011) suggests that more insider economies should be less conservative since less minority shareholders and better monitoring of management.

Tax book conformity: Firms from countries with high tax book conformity had incentives to recognize losses sooner (i.e. higher accounting conservatism) and recognize gains later. While taxes are generally computed on the individual financial statements (legal entities) and not on the 13 consolidated statements, many of the entity's choices and policies flow through to the consolidated statements. Mandatory IFRSs adoption is likely associated with a lower level of tax book conformity. Tax-book conformity is taken from Hung (2000). *TAXBOOK* includes only countries in the Hung (2000) study, thus, excludes Austria, Greece and Portugal. *TAXBOOKADJ* considers these countries as having high tax-book conformity. Low tax book countries under both classification schemes include Denmark, Great Britain, Ireland, Netherlands, and Norway. All other countries are considered as having high tax-book conformity.

2.5. Conservatism and mandatory adoption of IFRSs

How the introduction of a more neutral accounting regime will play out overall and across different countries in Europe remains an open empirical question. If IFRSs are more neutral than most national regimes in place, we would expect a decrease in conservatism. Further, if we do have convergence across countries, we should expect less difference across countries and institutional or legal regimes. It is also difficult to conjecture on the interaction of the mandatory adoption of IFRSs introducing a more neutral accounting system and of particular institutional factors present in each country which vary on many dimensions. As noted above, Watts suggests explanations for conservatism: contracting, shareholder litigation, taxation and financial reporting standard/regulation. I look at cross-country variation in conservatism with respect to these factors prior IFRSs and examine whether differences, if any, persist. More specifically, I examine differences in legal incentives, in corporate governance and enforcement, in the structure of the financial system, and in tax book conformity in order to develop testable hypotheses. Hence I formulate the following hypothesis:

"The mandatory adoption of IFRSs in 2005 leads to an overall decrease in accounting conservatism and a decrease of differences in conservatism across countries and legal/institutional regimes post-IFRSs."

Also about the conservatism current IASB chairman, Hans Hoogervorst talked on 18 September 2012, in Brussels. He stated:

"There are 2 problems with excessive conservatism. Firstly, during an economic upturn, profits are artificially depressed and investors might miss out a good investment opportunity. But the biggest problem kicks in during the downswing of the economic cycle. In those circumstances, hidden reserves can be used to artificially increase entity's earnings. Profits are overstated, masking the deterioration of the entity's performance. Again the casualty is transparency. The investor is likely to be misled and might be induced to hold on too long on his investments".

Determinants of an accounting quality after IFRSs adoption and factors that affect the accounting standards

Generally accounting standards, legal and political systems, and incentives of financial reporting all affect accounting quality. Although conversion to IFRSs is likely to affect financial reporting, it is only one of the determinants of overall accounting quality. Because other determinants will continue to differ across countries, it is possible that accounting quality will continue to differ across countries following IFRSs adoption. The quality of accounting is determined by the quality of the accounting standards.

If the IASB continues to improve the quality of IFRSs, we would expect financial reporting under IFRSs to become increasingly value relevant and reliable.

Comprix (2003) finds that positive market reaction to the news on the possibility of IFRSs adoption in the EU is related to the number of new disclosures and accrual measures under IFRSs relative to respective national standards. Burgstahler (2007) also finds that Comprix's index of new disclosures and accrual measures is significantly related to less earnings management in the EU.

However, opponents argue that a single set of standards may not be suitable for all settings and thus may not uniformly improve value relevance and reliability, especially given differences among countries. For example, Ball (2006) points out that pension accounting may be subject to earnings management especially in countries that have less mature pension systems. Managers can use different assumptions to manipulate their financial statements.

However, using a universal accounting method makes it less costly for investors to identify earnings management. Under a common accounting method, investors can easily compare different assumptions of pension accounting between firms and countries to evaluate the quality of financial reporting, which will put pressure on management to report truthfully.

Nevertheless, I think that using a single set of accounting standards may not improve accounting quality uniformly for each firm and country because of additional factors such as legal and political systems and incentives of financial reporting that may affect earnings quality. Legal and political systems influence accounting quality in several ways. First, they affect accounting quality indirectly through accounting standards.

Accounting standard setting is a political process, in which users of accounting such as tax authorities, banks, shareholders, managers, and labor unions have significant influence on standard setters. In an effort to reduce the political influence on standard setting, in 2001, the IASC was replaced by the IASB. The IASB is responsible only to a non-for-profit organization, the IASC Foundation. This change mirrors the model in the US, where the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) was replaced by the FASB in 1972 because of its lack of independence. Even with increased independence, the IASB continues to be under enormous pressure from global politics. This is perhaps best illustrated by the fair value accounting standards (IAS 39). Armstrong (2007) and Whittington (2005) document several instances where governments of some EU countries strongly voiced their concerns about IAS 39. The most active opponents were French President Chirac and the banking industries. Under IAS 39, banks must report fair values of their financial instruments and will thus experience increased volatility in their balance sheets and earnings. This may affect investor and regulator views of financial institutions' stability.

During the development of IAS 39, President Chirac took sides with French banks and expressed his concerns about the standard. As a result, The European committee endorsed IASs with a carve-out to allow hedging accounting for banks' core deposits, which is forbidden in both US GAAP and IAS 39.

Legal systems also influence accounting standards. Common law was developed in England during the eleventh and twelfth centuries, following consolidation of powers under the king and subsequent development of a judicial system to centralize control over courts. Decisions made by judges concerning common pleas brought before them formed the legal precedents that became known as common law. The result of this system was that royal influence on the legal system was diminished.

The separation between the executive and the judicial system, along with the notion of developing law based upon issues from the common people, are reflected in the approach to standard setting in common law countries. The right to set accounting standards is derived from information demands from investors, not from demands of the government. Accounting

standards in common law countries are mostly set by private organizations such as FASB in the US. The purpose of these standard setters is to satisfy investor needs for information. Code law (e.g., French and German law), on the other hand, was developed to allow governments to control setting and interpretation of laws. Accounting standards in these countries are a part of commercial law instituted by courts. Accounting standards in these countries are therefore primarily influenced by governmental priorities. In contrast to the role of accounting in providing information in common law countries, political influences in accounting standard setting in code law countries make accounting a measure to divide profits among governments as taxes, shareholders as dividends, banks as interests, and labor unions as salaries and wages (Ball et al., 2000). For example, under German GAAP, supervisory boards in Germany first determine dividends and then report profits because there is an excess tax on undistributed profits and German courts believe it is imprudent to report high profits without justification of low dividends (Ball, 2001; Leuz and Wüstemann, 2003). Ball (2000) finds that earnings in code law countries reflect economic profits in a less timely manner than dividends.

Legal and political systems also affect accounting quality directly, through enforcement of accounting standards and litigation against managers and auditors. La Porta (1998) finds that legal enforcement is higher in common law countries. Using their enforcement index, the international accounting literature has found that accounting quality is higher in countries with a common law origin and high protection of shareholder rights.

Hung (2001) finds that accrual accounting is more value relevant relative to cash accounting in countries with strong shareholder protection, but accrual accounting reduces the value relevance of financial statements in countries with weak shareholder protection. Francis and Wang (2007) find that earnings quality is higher for firms audited by Big 4 auditors compared to non-Big 4 auditors only in countries with strong investor protection.

This enforcement role of legal systems is especially important when considering the accounting quality following the adoption of IFRSs. The IASB issues IFRSs, but does not have enforcement power. Enforcement power thus resides in the security exchanges and courts where firms are listed. Legal systems vary significantly within the EU, and consequently we would expect accounting quality to vary across borders after the IFRSs adoption. In addition, IFRSs are principles-based, which means that auditors and accountants need to follow general principles rather than detailed standards and adapt these principles to specific situations. The legal system is therefore very important in determining accounting quality under situations that are not prescribed under IFRSs and need an interpretation of the principles. In countries with strong shareholder protection, it is expected interpretation will lean toward a fair presentation of information to shareholders. In countries with strong creditor protection, we expect interpretation to satisfy contracting demands of banks, such as conservative approaches to record assets but aggressive approaches to record liabilities. Consistent with this view, Ball (2006) finds that conservatism of a country is determined by the country's debt market size.

Political systems also directly affect accounting quality. Political rent-seeking is prevalent in countries with corrupt political systems. Firm managers and owners have incentives to bribe politicians to seek favorite treatment such as purchase orders from governments, lower tax payments, and monopoly status. They therefore have incentives to omit such bribes from financial statements to avoid political and social scrutiny. Moreover, firms in countries with a higher possibility of government interference are likely unwilling to show high profits in an effort to avoid government expropriation. Bushman and Piotroski (2006) find that firms in code law countries with high risk of government expropriation expedite bad news recognition.

Studies on cross-listing of firms provide another interesting insight into the effect of legal and political systems on accounting quality. Investor's price protect themselves by charging higher costs of capital or restrain provision of financing for firms in countries with low legal protection of investors. Firms in need of financing may therefore attempt to assure investors by listing in

exchanges with better rule of law, where violation of financial reporting regulation will result in sanction. Cross-listing firms thus have better accounting quality than their local counter-parts. Nevertheless, Lang (2006) finds that earnings quality for cross-listed firms in the US is lower than their US matched samples. They further find that the difference in earnings quality is associated with the legal system in the firm's home country.

Cross-listed firms from countries with low investor protection show more signs of earning management, suggesting that enforcement by the US SEC to foreign firms may be less stringent than for US firms. In addition, Leuz (2006) provides evidence that the low earnings quality of cross-listed firms compared to that of US firms may be caused by high ownership concentration in cross-listed firms.

Legal and political systems also affect accounting quality indirectly through the incentives associated with financial reporting. Financial reporting incentives stem from both the supply and demand for information. Ball (2001) argues that "all parties contracting or contemplating contracting with the firm demand information about the firm's ability to meet its contractual obligations. Firms therefore agree to incur the costs of supplying information, and in return they receive better terms of trade from factor owners and customer".

Financial reporting is therefore an equilibrium outcome from the cost of disclosure, which includes the cost of preparing financial reports and leaking proprietary information, and from the benefit of meeting contracting parties' demand for information.

The first financial reporting incentive that likely affects accounting quality is the development of financial markets. Demand for information results from market participants' need to reduce information asymmetry. Adverse selection happens when market participants cannot differentiate between good firms and bad firms. Without such differentiation, market participants would "price protect" themselves by increasing costs of financing to firms, and thus only bad firms would be willing to finance at these high costs.

Consequently, financial markets would mostly consist of bad firms. Spence (1973) finds that credible signaling can reduce this adverse selection problem. If signaling is more costly to low quality firms, high-quality firms will signal to the market at lower costs and receive lower costs of financing. Financial reporting is a primary mechanism used to signal to the market. Francis (2005) finds that firms in need of external financing voluntarily disclose more information than a country's minimum requirement and have lower costs of capital. Similarly, Huddart (1999) finds that even though liquidity traders are risk-neutral, they prefer to trade on high disclosure exchanges, which in turn motivates firms to raise funds on a high disclosure stock exchange to exploit the liquidity and lower costs of capital at the exchange. Burgstahler (2007) finds that public firms in countries with large and highly developed equity markets engage less earnings management than private firms in these countries. They attribute this finding to either:

- a) Stock markets providing incentives for firms to make earnings more informative to reduce costs of capital; or
- b) Stock markets screening out firms with less informative earnings.

Thus, the demand for information from market participants provides incentives for firm managers to improve the quality of financial reporting. Legal and political systems affect accounting quality indirectly through financial market development. Strong investor protection and lower levels of government expropriation guarantee investors a return on their investments and increases the number of investors who are willing to provide financing.

La Porta (1998) finds that the character of legal rules and the quality of law enforcement determine the size of capital markets. French law countries have the weakest investor protection and smallest equity and debt markets. La Porta (2006) examines the mechanism through which securities laws influence stock market development. While they do not find public enforcement mechanisms, such as independent regulators and criminal sanctions benefit stock markets, they

find that laws mandating disclosure and facilitating private enforcement of recovery of investors' losses benefit stock markets.

Countries with highly concentrated political and religious power are also linked to less developed financial markets. Stulz and Williamson (2003) find that a country's major religion is related to the size of its stock market. Leuz and Oberholzer-Gee (2006) find that firms with political connections are less likely to go public. Because the demand for accounting information is dependent on the nature of financial markets, and the legal and political systems impact the markets, characteristics of the legal and political systems will impact the quality of earnings, a common GAAP notwithstanding.

Firms with different financing needs have different incentives for financial reporting. Shareholders and creditors use different methods to reduce information asymmetry. When investors invest directly through a stock market, they rely on a company's financial reports and expend resources to acquire information. If, however, investors decide to lend through a bank, they deposit money in the bank and delegate the role of monitoring borrowing firms to the bank. Banks demand less financial reporting than do shareholders because banks have private access to firm managers.

The need for financial reporting to reduce information asymmetry is thus lower in Japan. Sun (2006) finds that the usefulness of financial reporting in improving capital investment decisions is decreasing with the level of debt financing.

Similarly, Ali and Hwang (2000) find that price leads earnings more in bank-based economies than in market based economies. Due to low reporting incentives, we would expect lower accounting quality in firms dependent on bank financing.

Legal and political systems also affect accounting quality indirectly through capital structures. In countries with high creditor protection, firms are more easily able to get bank financing at lower cost. In countries with high possibility of government expropriation and corruption, contracting is mostly completed privately to avoid social and political scrutiny, and financial reporting is a less frequently used method to reduce information asymmetry. Earnings quality is thus lower in countries with high dominance of bank financing and political risks.

Firms with concentrated ownership and high divergence between cash flow rights and control rights have low incentives for financial reporting. First, controlling stakeholders are active in management, thus reducing the demand for financial reporting. Ball and Shivakumar (2005) and Burgstahler (2007) examine the earnings quality of private firms in Europe, which are normally controlled by few shareholders and lenders. They find that earnings quality of private firms is lower than that of public firms, although both groups are subject to the same accounting, tax, and auditing standards. They attribute the findings to low demand for high quality financial reporting because stakeholders in private firms have easy access to firms' information. The low earnings quality of private firms also avoids leakage of proprietary information to the public and is thus an equilibrium outcome. Second, controlling shareholders have incentives to hide their exploitation of the wealth of minority shareholders. Pyramidal and cross shareholding gives an ultimate owner dominant control over a firm without a large investment in ownership. This divergence between control rights and cash flow rights creates an agency problem between controlling and minority shareholders and increases the incentives of controlling shareholders to hide the problem in financial reporting. Third, controlling shareholders have long-term interests in firms and will thus invest with a long-term purpose. These long-term investments may incur huge losses at the beginning but may yield large profits in the future. High volatility of earnings may not be good for these firms if they are in need of bank financing. Controlling shareholders therefore have incentives to smooth earnings.

Lastly, foreign investors may demand more information than domestic investors due to their lack of institutional knowledge. Kinnunen (2000) tests this argument in Finland, where, between 1984

and 1992, foreign ownership and domestic ownership were independently traded. They find that earnings from both the local accounting standards and IASs are value relevant for foreign ownership shares, but only earnings from local accounting standards are value relevant for domestic shares.

Legal and political systems may also affect earnings quality indirectly through ownership structures. La Porta (1998) finds that countries with stronger investor protection have a lower concentration of ownership. They argue that ownership concentration is a substitute for legal protection because:

- a) Shareholders need more control to avoid being expropriated by managers.
- b) Small investors are not interested in purchasing stocks due to less protection. Political systems also affect ownership structure.

A government with prevalence of political rent-seeking may cause concentration of ownership. Fan and Wong (2002) and Morck (1996) provide two arguments as to why closely-held firms are better at political rent-seeking. First, concentrated control and decision-making may appeal to politicians, who want to maintain a clean reputation, since secret lobbying and bribes are less likely to leak out from firms with fewer individuals engaging in lobbying decisions and activities. Second, a controlling owner has a more secure position than a hired manager in a widely-held firm. This security gives the company more credibility in trading favors with politicians. Legal and political systems thus affect ownership structure, which in turn affects earnings quality.

An important aspect of the legal system is the tax system. There are several ways that a tax system can affect earnings quality.

First, earnings are less likely to reflect underlying business in a country with a close linkage between financial accounting income and taxable income. A close linkage between accounting standards and tax laws reduces the quality of accounting standards, since they serve political purposes such as collection of taxes for the government.

Second, a high tax rate will increase the incentive to reduce taxable income. Taxable income and accounting income are linked even in countries with low book-tax conformity, such as the US. Therefore, a higher tax rate will increase the incentive to hide profits in financial reporting. Burgstahler (2007) finds that European firms in high book-tax alignment and high tax-rate countries manage earnings more.

Third, a country's tax authority has statutory power in verifying a company's profits. Tax authorities do not have the same free-rider problem as shareholders because there is no beneficiary of tax collection other than the government. Haw (2004) finds that a country's tax compliance is associated with lower earnings management and has a greater effect than judicial system efficiency in curbing earnings management.

Finally, legal and political systems affect accounting quality through tax systems. Unlike the role of financial reporting in code law countries as a measure of tax payment to the government, common law countries' financial reporting is used to reduce information asymmetry. Hung (2001) and Guenther and Young (2000) find that common law countries have lower book-tax conformity. Moreover, tax rates are determined via political processes. Ministries of Finance, the authority of tax collection, are appointed in a political process. Further, a country's level of corruption directly affects the effectiveness of tax collection process. Therefore, legal and political systems may influence tax systems, which in turn, affect earnings quality.

Chapter 3

Assessment of adoption in selected countries and pros and cons on financial reporting. Analysis of differences among financial statements prepared by entities from selected countries – effects of culture and history on adoption

3.1 Russia

Much has been written about International Accounting Standards (IASs), International Standards on Auditing (ISA), accounting harmonization, accounting education and accounting reform in transition economies in recent years. A few books and articles have focused on accounting reform in Russia. The classic book in the sub field of accounting reform in Russia is by Enthoven et al (1998). This paper discusses the Russian accounting system, management accounting, auditing, taxation and accounting education. A few years before that, Enthoven et al (1992) published a book on doing business in Russia and other former Soviet republics that dealt with accounting issues. This latter book was very popular among accounting practitioners who were doing business in the former Soviet Union, since it was one of the few major sources of accounting information on Russia at the time it was published. Bailey (1982) published a long historical study of Russian accounting going back to the thirteenth century. Shama and McMahan (1990) discuss the historical development of accounting in Russia from Tsarist times to communism and also how perestroika (rebuilding) will change the nature of accounting in Russia and other East European countries. Motyka (1990) discusses the impact of Western Europe on accounting development in tsarist Russia prior to 1800. Lebow and Tondkar (1986) discuss the development of accounting in the Soviet Union and its effectiveness. Two decades before that, Campbell (1963) published a book containing a series of essays on Soviet accounting problems. Campbell (1956) also did a long and detailed study of depreciation under the Soviet accounting system. Horwitz (1963) discusses some of the philosophical and historical literature on accounting in a socialist regime and focuses his attention on depreciation and cost. An early study by Mills and Brown (1966) discusses how shifting from a production model to a profitability accounting model would help Soviet enterprise managers make decisions that would increase the efficiency of their firms and help them to better allocate resources. In a similar vein, Thornton (1983) discusses changes in the way the Soviets accounted for factor costs over a twenty-five year period. A study by Scott (1969) states that Soviet accounting after the 1965 reforms started to place more emphasis on enterprise profitability, which helped move the Soviet economy closer to a Western market model. Other authors have also touched on this theme. Horwitz (1970) discussed the effect that decentralization has on the management accounting control system. Chastain (1982) described how the Soviet accounting system was not able to keep up with the needs of enterprise managers. He also assesses the implications of that inability for the accounting profession. Gorlick has done several studies on the Soviet accounting system. In one study he discusses the historical development and problems of uniform accounting (1974). In another he discusses planning and control (1974). In an earlier study he discussed the difference in accounting measurements between the Soviet Union and the United States and the advantages and disadvantages of their profitability measurements (1971). Richard (1998) wrote a book chapter that discussed communist accounting systems in Eastern Europe in general and in the Soviet Union in particular. Garrod and McLeay (1996) edited a book on accounting in transition economies, which provides a good introduction to many of the issues involved in attempting to convert the accounting system from a central planning model to a market model. One of the chapters in that book (Jaruga 1996) describes the changing accounting function in socialist countries, which is now mainly of historical interest. Turk and Garrod (1996) discuss the lessons Slovenia learned when it began the process of changing to International Accounting

Standards. The Slovenian experience is not unlike the Russian experience in many ways. Preobragenskaya and McGee did research on the relationship between IFRSs and foreign direct investment (FDI) in Russia (2003) and on the state of auditing in Russia (2003). Their FDI study concluded that the lack of credibility of Russian financial statements was hampering inflows of foreign capital. Their audit study found that the state of auditing in Russia is not yet up to western standards. A few studies have been made on accounting education in Eastern Europe or the former Soviet Union. Houghton Mifflin's 1300-page *Principles of Accounting* was the first Western accounting text sold in the Soviet Union (Collingwood 1991). It was translated and distributed by *Finansy I Statistika* (Finance and Statistics), Moscow's government owned publisher. Kobrack and Feldman (1991) speculated whether the reform process in the Soviet economy could create a new market for accounting textbooks. McGee has written about educating accounting professors in Bosnia & Herzegovina (2003a) and reforming accounting education in Armenia (2003b).

There are several sources of information on recent developments in accounting reform in Russia. The International Center for Accounting Reform in Moscow (www.icar.ru/) publishes the *ICAR Newsletter*. The World Bank publishes *Transition Newsletter*, which gives current information about various aspects of market reforms in transition economies, including accounting reform in Russia. The Russian websites of the Big-Four accounting firms also have current information and, in some cases, publications. The Deloitte Russian website has an e-library link that contains a variety of items on various aspects of doing business in Russia. It has a *Doing Business in Russia Online Guide*, which includes much information on accounting and tax topics. It has several newsletters that address accounting, tax and legislative issues on various countries, including Russia. *Russia - Legislative News* is a monthly newsletter that contains accounting and tax items. *Legislative Tracking* is a daily publication that keeps readers abreast of Russian pending legislation. Ernst & Young publishes *An EYE on Russia*, a monthly newsletter on current business, accounting and tax issues. It also has a Russian Legislation website that contains downloadable documents on Russian accounting, tax and related legislation that have been translated into English. The KPMG Russian website has several good publications, including *Doing Business in Russia* and *Russia – Tax Overview*. The PricewaterhouseCoopers website has several publications pertaining to Russia, including *Doing Business in the Russian Federation* (2003). There are also a number of short articles by PwC partners and others on various aspects of accounting reform in Russia, including an excellent article by Leonid Schneidman (2003) on the long road to IFRSs adoption.

Some publications have compared the accounting standards in various countries to IFRSs. The most thorough study is GAAP 2001, a joint publication of several large international accounting firms, which makes comparisons for 62 countries, including Russia. Several of the Big-Four accounting firm websites have a link to this study. The International Forum of Accountancy Development website (www.ifad.net) has published this study in interactive format. There is also a *GAAP Comparison 2000* study that provides comparisons for 52 countries and a small 2002 update titled *GAAP 2002 Convergence* that provides data on 59 countries. Street (2002) has written a summary of the GAAP 2001 study. The internet also has information on corporate governance in Russia. One good source is the Independent Directors Association website, which contains much up to date information on corporate governance in Russia. It publishes *Independent Director*, a quarterly review and has also published *The Code of Conduct of Independent Directors* and *The Independent Directors Association Charter*, both of which are published in the spring 2003 issue. The Organization for Economic Cooperation and Development (OECD) website also has current and relevant information on corporate governance in Russia. *The Russian Code of Corporate Conduct* can be accessed from several websites, including the Deloitte Russian website. The Corporate Governance Code can be obtained from the Russian Institute of Directors website (www.rid.ru).

Methodology: The first stage in the my preparation was a thorough review of the literature on accounting reform in general and accounting reform in Russia with special attention being paid to the literature that discussed the adoption and implementation of IFRSs. As the literature was being reviewed, the authors started compiling a tentative list of questions to ask Russian accounting experts on various aspects of accounting reform in Russia.

3.1.1 Problems of implementing international standards in Russia

Accounting has a long history in Russia, going back at least to the thirteenth century, through the time of the tsars and through the communist era. The Russian accounting system started shifting away from the centrally planned, socialist model as early as the 1960s. The pace accelerated with perestroika (rebuilding) and the collapse of the Soviet Union, which began in the late 1980s. A critical year for Russian accounting was 1989. It was in that year that the Soviet government introduced legislation for joint ventures using foreign capital. This decision created a real need to modify the Russian accounting system and led to the introduction of new Western accounting concepts like audits, intangible assets, capital, etc. Some scholars have gone on record as saying the reason for the collapse of the Soviet Union was because of the inability to allocate resources efficiently under a socialist accounting system. Ludwig von Mises, an Austrian scholar who later taught at New York University, predicted the collapse as early as the 1920s (Mises 1920; 1922; 1923; 1935). His prediction sparked the socialist calculation debate of the 1930s (Hayek 1935; Lange 1936; 1937; Lerner 1935; Lippincott 1938; Hoff 1981). Polanyi (1923) agreed with Mises that the problem of economic calculation is insoluble in a centrally planned economy but proposed to solve the problem by means of “a functionally organized socialist transition economy.”

Whatever the reason(s) for the collapse of the Soviet Union, there has been a worldwide movement on the part of formerly centrally planned economies to move away from the top-down, centrally planned accounting model and toward a bottom-up market model. Russia started to make the transition by deciding to adopt and implement international standards. Although Russia chose to adopt and implement international standards several years ago, there are still some deficiencies in the system. Until recently, deducting the cost of IFRSs audit was not allowed by the Russian tax code, which took some of the incentive away from having such an audit. Russian accountants and auditors are not sufficiently well versed in international standards to implement them, with a few exceptions. There is a widespread perception on the part of accountants who work for the large international accounting firms that none of the Russian accounting firms, even the biggest ones, are able to provide high quality service regarding international standards. The large international accounting firms, mostly the Big-Four, have rushed in to fill the gap to provide the services and expertise that the local Russian firms cannot provide. This capturing of market share by the big firms has caused some resentment on the part of the smaller Russian firms. It has also given some Russian accounting firms an inferiority complex, since they know they do not have the resources or expertise to compete against the international firms. Russian accounting firms have lost some large clients to the Big-Four. However, some of their big clients later returned, partly because of cost considerations. Russian accountants and auditors who were trained under the old system need to learn the new system and many of them have not. Some of them, especially the older ones, are actively resisting the change. Some Russian accountants and professors, even at the top, insist that they use or teach international standards, even though they have never read them. There is the widespread perception that Russian Accounting Standards (RAS) either are the same as the international standards or are just as good. In fact, there are major differences. RAS are more form over substance, whereas the international standards are more substance over form. There is also the perception that international standards are not needed, either because the RAS are just as good as the international standards or because there is no demand for international standards. There is a

grain of truth to the lack of demand argument. Until a few years ago, the only reason most firms prepared financial statements was to provide information to the tax authorities. Some firms still prepare financial statements just for the tax authorities. However, the trend now is away from having a monopsony (single user) of accounting information, especially with the large Russian firms, since they need to go to the international capital markets for funds to expand or stay afloat. Foreign investors demand to see financial statements prepared using either IFRSs or GAAP as a condition of talking seriously about investing in a Russian company. It would not be an overstatement to say that companies prepare statements using either IFRSs or GAAP only because they need to in order to obtain a listing on some foreign stock exchange or because their creditors or investors demand it. The demand for such statements is therefore limited, especially when companies prepare such statements at the consolidated level. It is typical that subsidiaries prepare statements based on RAS and that GAAP adjustments are made at the top, even though the people who provide the information used for consolidation are further down the organization and know nothing about GAAP principles. Top corporate managers seldom use consolidated information for management decision making purposes, since such information has no value to them. This valuelessness of IFRSs or GAAP consolidated financial statements is especially true for tax managers, since they use only the RAS statements for computing the company's tax liability. Although the trend is to place more emphasis on the needs of shareholders and potential investors and less on the needs of tax authorities, not all Russian accountants and managers feel this way. Most accountants who work for the big international accounting firms, and many of their clients, now recognize the goal of financial statements is to provide information to shareholders, not the tax authorities. This change in attitude and perception started to take place around 1999 or 2000. This change in attitude has not yet filtered down to the smaller firms and enterprises. Although the big accounting firms and an increasing number of large enterprises now recognize that the main audience for the financial statements they prepare are shareholders, the smaller Russian companies still think that accounting information is only for the tax authorities. Some CEOs at larger companies still think this way. This attitude is reinforced by the Russian tax authorities themselves, who often could not care less to see any financial statements based on international standards. The Russian tax rules are different from the IFRSs, so why bother to look at financial statements that are prepared using the IFRSs? They want to look only at statements prepared using RAS. One of the partners interviewed at one of the international accounting firms said he was tired of having to sign off on two sets of financial statements, one based on RAS and one based on either IFRSs or GAAP. He longed for the day when he would need to sign off on only one set of statements. He also confided that such a day is likely far off, since statutory accounting still requires the use of RAS and this rule is unlikely to change any time soon. Not all Russian enterprises that are trying to attract foreign capital are using IFRSs. Some of them are using US GAAP. One of the deciding factors that enters into the decision to use one or the other set of internationally recognized financial reporting standards has to do with which capital market the enterprise wants to tap into. If they are targeting the United States capital market, they often decide to use US GAAP. Those who decide to tap into the European capital market often choose IFRSs. Russian enterprises used to prefer US GAAP to IFRSs because they wanted to list their shares in New York. The trend is now toward IFRSs because of the Enron and Arthur Andersen scandals. However, not all firms are shifting to IFRSs. The subsidiaries of the many US firms in Russia prefer GAAP, so it appears that there will be a need for GAAP-trained accountants for the foreseeable future. The interviews revealed that there is a bit of standards shopping going on the part of some Russian enterprises. In one case, an enterprise would have had a multimillion deferred tax liability using one set of standards, whereas their tax liability using the other set of standards would have been zero. One set of rules would have treated the book tax difference as a permanent difference whereas the other standards would have treated the difference as a timing difference, and thus subject to deferral. Not surprisingly, the enterprise chose to use the set of standards that did not result in a tax liability. Some Russian audit firms will agree to sign anything, including an audit report, lest they lose a

client. Or at least that is the perception. Unfortunately, there may be some truth to this perception. Russian business culture is different than Western business culture in this respect. Three generations of communist governments and the accompanying corruption that went with it have made people cynical. Many people simply do not believe that financial statements signed by a Russian audit firm are as credible as statements signed by a Western audit firm. One solution to this dilemma would be to establish a strong private sector accounting organization like the American Institute of Certified Public Accountants (AICPA) or one of its British counterparts that is capable of policing its members and giving much needed moral support to the Russian audit firms that do not want to give into the pressure to sign audit opinions when financial statements are not of sufficiently high quality. This solution was proposed both by the Russian firms that were interviewed and by some members of the Big-Four. Unfortunately, no such private sector accounting organization currently exists and none are on the horizon. There are a number of small, politically weak accounting organizations, but they do not have the authority, power or incentive to do the policing job or to provide the moral authority needed to support the honest Russian audit firms that want to do the right thing. It is encouraging that Russian accountants have identified the problem and have a good idea of where the solution might lie. The next step is to find a way to achieve the desired result. That will not be easy, at least for the immediate future, since the Russian accounting profession, in the Western sense of that term, is in its infancy stage. There is no recent history of private sector institution building in Russia and the other former communist countries. The only institution was the State, and in some cases, the church. Private sector institutions will need to be created and grow in size and strength, and that process will take time, perhaps a generation or more. In general it seems unrealistic to expect such any independent organization to be established and function in Russia because it is against the Russian management culture to have such organizations.

Some of the individuals interviewed pointed out that part of the problem is that the professional accounting organizations that do exist have a bias in favor of the status quo. So do Russian bureaucrats. Milton Friedman discussed this inertia problem in theoretical terms several years ago (Friedman and Friedman 1984). One of the interviewees said that these people do not know anything about international standards that they do not have the required skills and that changing to international standards could put them out of a job. Outside help is available for strengthening these private sector accounting associations. George Soros and his various foundations have recognized the need to build and strengthen private institutions and have allocated millions of dollars toward this goal. The various USAID and Tacis accounting reform projects include an institution building component in their projects. The problem with some of these institution building projects is that they turn out to be top-down. The local accountants and existing accounting organizations need to be convinced that they need to build such institutions. The institution building process would go faster and smoother and would be more successful if the process were demand driven, with the demand emanating from the grass roots rather than from some international organization that offers to drop money and consultants on the problem.

Another structural problem with Russian accounting is the Russian mindset. Under the old centrally planned system, accountants were really bookkeepers. They didn't have to make decisions. Their job was just to make journal entries. There was no such thing as exercising professional judgment. Where a decision had to be made, their solution was to look for some rule that told them what to do. The new rules, whether IFRSs or GAAP, require the exercise of professional judgment and many Russian accountants do not feel comfortable making decisions on their own. They would prefer to find some rule in a book that instructs them on how to do everything and they resist adopting the new rules. This structural bump in the road to the adoption and implementation of market based accounting rules will be worn down with time, but it will take perhaps a generation or more before Russian accountants think the same way as Western accountants in regard to this approach to decision making.

Several government ministries are involved in accounting reform. Unfortunately, they do not always think the same way. In fact, their approaches to accounting reform are drastically different. The Ministry of Economic Development and Trade is strong on policy formation but does not have much power over policy implementation. Its approach is bottom-up. The Finance Ministry, on the other hand, prefers a top-down approach, similar in structure to the old centrally planned Soviet system. Westerners feel more comfortable dealing with the Ministry of Economic Development and Trade, since Western accountants also prefer a bottom-up approach. However, these two ministries are not the only government agencies that are involved in accounting reform. The Russian Securities Commission and the Central Bank also play a role. In 2002 the Association of Russian Entrepreneurs also became involved in accounting reform. But no one is in charge. There is no leadership. There is no central direction to accounting reform. It is almost like all of these institutions are groping in the dark. While some government ministries demonstrate an interest in accounting reform, they are unable to answer questions because of a lack of expertise.

There is no force driving accounting reform from an organizational perspective. No organization wants to protect both accounting and the public interest. The pressure to reform accounting in Russia is coming from the market. Russian enterprises that want to raise capital, either by debt or equity financing, need to have statements prepared either according to IFRSs or GAAP. Potential investors demand it. That is the factor that is causing the change, not some government bureaucracy that dictates policy and rules from on high. Most of the largest companies, like Gazprom, Aeroflot, metallurgical plants, electricity plants, etc., including 80 percent of the biggest companies and 95 percent of banks prepare financial statements based either on IFRSs or US GAAP. The real driver of accounting reform is the large companies. They are doing it in spite of government inaction. The market is solving the problem without government.

3.1.2 International standards in Russia

Accounting is part of the legislative system. That is a problem because Russia will never have true international standards if government has to legislate it. There will always be a lag and style and language problems. The original plan by the Russian Finance Ministry in 1998 was to adopt all IASs by 2000. That did not happen. The new target for full adoption and implementation was 2004, at least in the case of banks and publicly traded companies. However, that target was not fully met. In fact, not a single accountant interviewed thought that international standards would be fully adopted and implemented by 2004. One research had estimated that full implementation would take another decade. Even though Russia is in the process of adopting international standards, it has not adopted all of the international accounting standards, and it has no immediate plans to adopt the standards it has not already adopted. It has not adopted the standards on financial instruments or deferred tax calculation (this hesitancy is not unique to Russia. The same situation exists in Serbia, Bosnia & Herzegovina, and in other formerly centrally planned economies).

Perhaps the main reason why the standard on financial instruments has not been adopted is lack of demand. Very few Russian enterprises use complex financial instruments, and the ones that do are already applying the IFRSs or US GAAP on this topic. Also, this standard is difficult to understand and many Russian accountants are not eager to make the effort to learn a standard that they probably will not use in the foreseeable future. The standard on hyperinflation is not needed, or at least that is the perception of many Russian accountants, because Russia's inflation rate has fallen below the threshold needed to trigger the hyperinflation standard. Russia's cumulative inflation over the most recent three years has been about 90 percent, and the threshold for using the hyperinflation standard is 100 percent. But the 100 percent test is only one of five items on the IFRSs list of possibilities. To be more compliant with IFRSs it is

necessary to look not only at quantitative factors but also qualitative factors. For example, Russian companies do their planning in dollars, not rubles. If the ruble is not being used to make management decisions, a strong argument can be made that the hyperinflation accounting rules should be used even if the inflation rate does not hit the 100 percent minimum threshold.

Another point that could be made about Russia's adoption of international standards is that even the standards that have been adopted may not always be international standards. For example, the Russian standard on income taxes is based on the old version of the IFRSs income tax standard, not the new one. This fact is known within much of the Russian accounting community but may not be as well known outside of Russia. Another, less well known fact about Russia's accounting standards is that the Russian version of the standards that have been adopted are not mere translations of the English language originals. In many cases they are abbreviated, simplified versions of the original English language IFRSs. RAS tend to be much shorter, more detailed and conceptual. They cover a fraction of the content of IFRSs. In short, it may not be accurate to state that Russia has adopted IFRSs in full. It would be more descriptive to say that Russian accounting standards are merely based on IFRSs. Often the differences between RAS and IFRSs are not large or important. However, the difference may be substantial, such as in the area of accruals principles.

Differences between Russian accounting standards and international accounting standards in 2013:

- The Fair Value concept is not applied
- Most of financial instruments are accounted for at cost or amortized cost (less impairment provision)
- Finance leases may be capitalized or expensed by agreement of the parties to the lease contract
- PPE is not impaired, but revaluation to current replacement cost is allowed.
- The useful lives of fixed assets tend to be in line with the useful lives specified for tax purposes.
- Deferred tax is calculated using the income statement method, although the methodology differs.
- Revenue or expenditure are generally recognized after primary documentation supporting the transaction has been received in accordance with the tax rules.

Source: <http://www.iasplus.com/en/jurisdictions/europe/country>

These all list the differences between RAS and IFRSs. The problem with these lists, which is not revealed in any of these publications but was discovered during the course of the interviews, is that these compiled lists of differences do not include mention of any RAS that is an abbreviated, simplified version of the English language IFRSs. For example, if the English version of IFRSs is 80 pages long and the RAS on that topic is 10 pages long, IFRSs are not included in the list of differences, even though the Russian standard is clearly not identical to the international standard. Thus, these comparative lists are deceptive because they do not reflect the true and total differences between RAS and IFRSs. The list is relatively short, and many items on the list are for items that are inconsequential, leading an unsophisticated reader to believe that the differences between RAS and IFRSs are small, when in fact the differences can be quite large for certain standards. It was pointed out during the interviews that there are really no detailed comparisons between IFRSs and RAS but only the superficial kind of comparisons like the one above.

Another problem with making comparisons between RAS and IFRSs or GAAP is historical. IFRSs have a historical base. International standards are based on more than 100 years of Anglo

accounting evolution. Because of that, much is understood but not stated. The Russian accounting system has no such long history. There are differences of interpretation and emphasis even within the Western market economies that have adopted IFRSs or some similar set of rules. For example, a German accountant and a British accountant could interpret the same rule differently for cultural reasons. Germans are more conservative and would tend to make provisions that British accountants might not make. Germans provide for everything; British and Russian accountants provide for fewer things.

Some of the individuals' interviews stressed the point that RAS will never be identical to the international standards. They will never be a mere translation, even if every word in every international standard is translated directly into Russian. That is because Russian culture and Russian thought processes come into play. The way Russian accountants interpret the rules will always be different than the way an English accountant will interpret the language contained in the various international standards. The problem is about interpretation, not the translation itself, although the translation creates some complicated problems such as terminology, etc. One reason for the differing interpretations is because of conflicts in definitions.

IFRSs contain definitions for a great many terms. So does the Russian Civil Code. But the Civil Code definitions are often different from the IFRSs definitions. What is a Russian accountant to do when confronted with these differences? These differences have caused arguments with clients in the past.

These definitional problems will not go away in the near future if for no other reason than because the Russian Duma (Parliament) has more important things to do than expend a lot of effort harmonizing accounting definitions with the already existing Civil Code definitions. This problem would be nonexistent if the accounting rules were formulated in the private sector, but they are not. When this possibility was mentioned to one of the partners of a Big-Four accounting firm in Russia, his reply was that he did not believe that having the private sector harmonize definitions would be better than having the Duma do it. Then, rather cynically, he added that the Duma is very much an extension of the private sector. Another reason why RAS will never be identical to the international standards is because there is a timing lag between the time a new international standard is issued in the UK and the time that new standard is translated into Russian and adopted as part of the Russian accounting rules. This lag could be overcome if the Russian Duma made it a rule that all new international accounting standards will automatically and immediately become part of the Russian rules. However, the Duma will never make such a rule, for reasons of national pride and sovereignty. So the lag will be permanent, even though there is a theoretical solution that would correct this lag.

The degree to which the Russian accounting community understands the international standards depends on several factors. The Russian translation of the original English version of the standards was not available until late 1998. The translation was mediocre, in some respects. Part of the problem was because there were no Russian terms to convey some of the concepts. In other cases, the Russian translators simply used the wrong word or said things in such a way as to make the sentence or phrase unintelligible. In at least one case, the translator left out the word "not," with the result that the Russian version of the standard instructed the reader to do something, when in fact the English version of the rule said "not" to do something. These kinds of mistakes and imperfections are to be expected the first time a technical document is translated, especially in cases where no terms exist for some of the words and ideas that need to be translated. The Russian accountants who cannot read English are limited to reading the Russian translation of the international standards. That places them at a competitive disadvantage, for the reasons mentioned above. The Russian translation is mediocre in some places and in other places is downright incorrect. The Russian speaking accountant has no way of knowing how accurate the reading of a particular sentence or paragraph might be, but must rely on what is written because there is no other alternative. Russian accountants who were educated in a university that

did not teach the international standards have a problem reading the international standards in any language because the standards contain concepts that the Russian accountant was never exposed to during the years at the university. Such accountants must learn the new rules as best they can, either by self-study or by attending some lectures or seminars on the various topics. The interviews revealed that the Big-Four accounting firms have found a way around this translation problem, which gives them another competitive advantage over the local Russian firms. The Big-Four have a tendency to hire people who speak English, and at least one of the Big-Four will not hire anyone who does not speak, read and write English. The accountants who work for these firms refer to the original English version of the international standards and do not even read the Russian version, except perhaps as a secondary reference. Thus, they avoid all of the problems that are inherent in relying on the Russian translation. Another advantage that the Big-Four firms have over their Russian-only brethren is the materials on international standards their various affiliate firms have developed over the years. The Big-Four branches in the United States, the UK and elsewhere have, over the years, developed a great deal of reading materials and some case studies that address many of the questions and problems that pop up when accountants try to apply the international standards. These materials are available to the employees of the accounting firm and also to their clients. The Big-Four firms also have regularly scheduled educational programs for their employees and clients, whereas the other Russian firms may or may not have such programs. This wealth of educational material gives the Big-Four accounting firms an additional advantage over their Russian competitors. They can offer their clients an education that most Russian accounting firms cannot compete with. Much of the client training they provide is free. The training that they do charge for is offered at a very reasonable price. One reason for the low price is because many Russian enterprises cannot afford to pay New York or London prices.

Another reason has to do with Russian culture. Russians are accustomed to getting free education. They do not see the need to pay high prices for education. This attitude affects the ability of the large accounting firms to charge a price that is high enough to meet their costs. Another problem with the implementation of international standards that the interviews revealed is that the Russian accounting community operates as a two-tier system. The accountants who work in Moscow, St. Petersburg and a few of the other large cities are more knowledgeable about the international standards than the accountants who do not work in the large metropolitan centers. The big city accountants have more and better access to accounting materials and courses that will help them to keep current with recent developments, or even to become familiar with the basics of international standards. Accountants in the outlying regions do not have this kind of resource at their disposal. Perhaps they have internet access, which would enable them to tap into some pertinent information that is available on the net, but even internet access is not as good outside of the big cities as it is within them and it is expensive by Russian standards. However, much of the information available on the internet is useless if the accountant cannot read English, since there is much information available in English that is not available in Russian. Also, the Big-Four accounting firms do not have offices in the smaller Russian cities, so the infrastructure they carried with them to Moscow and St. Petersburg is almost totally absent outside of those two cities.

Another reason why the accountants in the outlying regions are not as knowledgeable about international standards as are the big city accountants is due to differences in demand. Most clients that need statements prepared according to international standards are in Moscow or St. Petersburg. A few big enterprises are scattered around other parts of Russia, mostly in the bigger cities. The accountants who service smaller clients have little or no need to know the international standards, so they do not take the time to learn them. The result is a two-tier system where the accountants and the employees who work for their clients in Moscow or St. Petersburg know at least something about international standards, whereas their counterparts in the outlying regions know less, or perhaps nothing about international standards. This situation is unlikely to

change soon. Some accountants and even university professors who live in the regions have never seen the Russian translation of IFRSs and have not seen any Russian accounting books that discuss IASs.

The drive to adopt and implement international standards is coming more from the market than from the Russian government. Although the government is pushing for adoption and implementation of international standards, the force that is really motivating Russian enterprises to use international standards is the carrot of foreign capital. Foreign investors simply refuse to consider making loans or investing in a Russian company that does not prepare its financial statements using either IFRSs or GAAP. Russian enterprises are also under pressure from the international investing community to have their statements audited by a large foreign audit firm such as one of the Big-Four. So the process of adopting and implementing international standards is more of a bottom-up system than a top-down system. The market is causing the changes to be made where they need to be made and it is doing it faster and better than what could be accomplished by mere government decrees.

Another interesting facet of Russian accounting that the interviews revealed was how Russian accounting firms and enterprises are dealing with the new disclosure requirements. IFRSs and GAAP both require much more disclosure than what Russians are accustomed to providing. Many Russian executives and accountants feel uncomfortable providing so much disclosure. Russian culture, even before the communist era, produced a closed mouth society, at least as far as revealing information to bureaucrats, government officials and the general public was concerned. Disclosure is new to the Russians and some of them do not know how to deal with it. Financial statement disclosure is sometimes more detailed than in the West, but the quality is often lower. Russian accountants tend to disclose information that has little or no value. They sometimes report extraneous information because they do not understand what is relevant for disclosure purposes. They do not always know what information is important to potential foreign investors, so they report what they are most familiar with. They provide financial statement ratios, disclose the number of employees, and so forth but sometimes leave out information that foreign investors might want to know. Some Russian financial statements are flooded with information that is of little or no use for investment decision making purposes.

3.1.3 Corporate governance in Russia

As Russian firms became privatized, they went to foreign capital markets in search of investment capital. Their initial attempts at raising investment capital were extremely difficult, for a variety of reasons, some of which had to do with the accounting methods they used. In the early stages of transition, the vast majority of Russian firms used Russian accounting standards to prepare their financial statements. That made sense when Russia was using the centralized, socialist accounting model, but western investors were not familiar with RAS and did not trust them. The main function of RAS was to provide information to the government under the old centralized system and to tax authorities under the new market system. But foreign investors require a much different focus. They are more interested in profits, disclosure and transparency. RAS did not provide sufficient information in a format that foreign investors needed, which made it very difficult for Russian firms to obtain the foreign capital they needed. The Russian firms that wanted to raise foreign capital started issuing two sets of financial statements, one based on RAS and the other based either on IFRSs or on US GAAP, depending on which capital market they targeted. This dual set of financial statements presented several problems. For one, the cost of preparing two sets of financial statements greatly increased the cost of preparing financial statements. Firms could not issue just IFRSs or GAAP based statements because the law and the tax authorities required RAS based statements.

Another problem they encountered was increased confusion on the part of financial statement readers. Potential investors and creditors were confronted with two different sets of financial data. Which set could they rely on? Profits, assets and a number of other items differed between the RAS based statements and the IFRSs or GAAP based statements. Financial statement readers in the United States faced a similar dilemma when FASB 33 was issued in the late 1970s. That Statement required some firms to provide a full set of regular financial statements as well as supplementary statements using two different kinds of inflation accounting. The result was three different valuations for assets, which led to confusion within the accounting community. Auditing such financial statements was another obstacle to obtaining the needed capital. Practically none of the Russian audit firms knew or used International Standards on Auditing (ISA) when they performed their audits. The only audit firms able to perform such audits were foreign firms, mostly the Big-Five (now four) accounting firms and a few second-tier firms that were able to gain a foothold in the Russian market. This lack of ISA audits is complicated by the fact that many chief corporate accountants want an audit to be a tax audit, which is what many (but not all) audits of local companies really are.

There is also a problem of transparency, or the lack of it. A survey conducted by PricewaterhouseCoopers of transparency in 35 countries ranked Russia number 34, just ahead of China (Haigh 2001). With such a lack of transparency it is little wonder why Russian firms find it so difficult to raise foreign capital. Russia is attempting to overcome this problem by instituting good corporate governance principles such as the appointment of independent directors, establishing audit committees and insisting on more financial disclosure. However, it should be pointed out that transparency is not the only thing that drives foreign direct investment (FDI). If that were the case, Russia would be receiving more FDI than China, which is clearly not the case. Transparency is an important factor in attracting FDI, but other factors also need to be considered. A number of detailed publications on corporate governance in Russia have been issued in recent years. One of the most frequently referred to publications is the OECD *White Paper on Corporate Governance in Russia* (2002). This publication provides detailed guidance on a number of corporate governance topics, including shareholder rights, the role of stakeholders in corporate governance, disclosure and transparency, the responsibilities of the board, and implementation and enforcement. The appendices also contain useful information on the relevant organizations and corporate governance initiatives in Russia between 1999 and 2001 and the Russian regulatory acts on corporate governance.

3.2 China

Following the financial difficulties in Southeast Asia, pressure has mounted for the development and adoption of global accounting standards. In October 1998 the Group of Seven leading industrial nations endorsed International Accounting Standards (IASs) as appropriate global financial reporting standards. At approximately the same time, the World Bank challenged auditors to refuse to give "clean opinions" on financial statements not prepared in accordance with internationally acceptable standards. Proponents of global accounting standards argue that they facilitate comparisons of companies' financial performance across countries, thereby enhancing the efficient allocation of resources in an increasingly global capital market. For example, Sir Bryan Carsberg, Secretary-General of the IASC argued that:

"Investors will no doubt take the trouble to analyze the annual reports and consider investment in some of the largest companies in some of the largest countries. They may invest in these companies, requiring a premium rate of return that is imposing a premium cost of capital, to compensate them for the costs of the analysis and the uncertainties they feel about the results of using an unfamiliar or deficient accounting system. In many other cases, investment may just not be considered because the costs and uncertainties are too great. So the use of different accounting rules in different countries limits the efficiency of the capital markets in attracting investment funds to the applications where they will earn best returns and therefore has some depressing effect on economic growth in general."

However, there are important unanswered questions about the value of global accounting standards. For example, standards developed by the leading international regulatory body, the International Accounting Standards Committee (IASC), are primarily based on those for countries with highly developed capital markets, such as the "Global Issues and Implementing Core International Accounting Standards: Where Lies IASC's Final Goal?" Remarks of Sir Bryan Carsberg at the 50th Anniversary Dinner, Japanese Institute of CPAs, Tokyo, 23 October 1998.

It is questionable whether such standards are also optimal for developing and transitional economies that lack the infrastructure for monitoring managers' financial reporting decisions. The usefulness of financial information prepared under IFRSs is, therefore, an empirical question for developing and transitional economies. In this part of my thesis I try to examine the usefulness of IFRSs standards using accounting and stock price data from the Peoples Republic of China (PRC).

PRC provides an interesting setting for studying the relative value of international accounting standards. At the formation of a stock market, the Chinese government required that separate markets be created for domestic and international investors. Domestic and international investors, therefore, trade stocks that are ostensibly claims on the same underlying assets but in different markets (and at different prices). In addition, PRC firms are required to report to domestic investors using local Chinese accounting standards and to international investors using IFRSs. There are several reasons to expect financial data prepared under IFRSs to be more useful than that based on Chinese standards.

First, IFRSs have permitted managers to exercise more reporting judgment to reflect differences in firms' business economics. Chinese standards, on the other hand, have tended to be bright-line rules that provide little opportunity for financial reports to reflect business conditions.

Second, international audit firms have audited IFRSs financials, whereas local Chinese firms which face challenges in attracting and retaining qualified personnel and in maintaining independence, have typically audited financial statements prepared under Chinese standards.

However, there are also reasons to question the usefulness of IFRSs data for Chinese companies. China, like other transitional economies, is only beginning to develop the infrastructure required

to support credible financial reporting. Its universities and schools have just started to train business professionals. Second-hand asset markets are in their infancy. Bond rating firms and financial analysts have little experience with the Chinese market. There are questions about the freedom of the financial press and whether shareholder rights are protected adequately under the legal system. And there is limited regulation of the financial market and enforcement of regulations. As a result, the control mechanisms designed to prevent managers from using financial reporting judgment under IFRSs to promote their own job performance, rather than to communicate the firm's economic performance to investors, are likely to be inadequate in China. Given this limitation, investors may find that local bright-line rules produce more reliable information than IFRSs.

3.2.1 Development of Chinese stock market

The Shanghai and Shenzhen Securities Exchanges were created in November 1990 and April 1991 respectively. Since their inception, these markets have required that domestic and international investors own different share classes. Domestic individuals and institutions are permitted to trade 'A' shares that are quoted in Chinese currency (renminbi or yuan), and listed on either the Shenzhen or Shanghai Stock Exchanges. Nondomestic investors are able to trade any one of three classes of Chinese shares: 'B' shares listed on either the Shenzhen or Shanghai Exchanges, 'H' shares listed on the Hong Kong Stock Exchange, and for a few companies, 'N' shares traded on the New York Stock Exchange. 'B' shares listed on the Shenzhen Exchange and 'H' shares are quoted in Hong Kong dollars, whereas 'B' shares listed on the Shanghai Exchange and N shares are quoted in US dollars. Each of these classes of shares nominally carries the same voting, dividend, and liquidation rights. By May 1998, there were 395 A shares and 51 B shares listed on the Shanghai Exchange, and 370 A shares and 54 B shares on the Shenzhen Exchange

Table 2

		Stock exchanges market		
		Shenzhen or Shanghai	Hong Kong	New York
Shares	A	X		
	B	X		
	H		X	
	N			X

Source: Taiwan Economic Journal Mainland China Database Data Book, 1998

Prior to 1998 firms were permitted to list multiple classes of shares. Since then firms have been required to choose a single listing exchange and share class. Companies listed on Chinese and international exchanges have several interesting features. First, almost all were formerly State Owned Enterprises (SOEs). Entrepreneurial enterprises which many believe to have been the most successful firms in China have typically been funded by banks and private equity capital. Second, the decision to list a company remains largely a political one, with the government balancing the interests of different ministries and geographic regions in China. Finally, the Chinese government has typically retained a majority ownership in these firms after the initial public-offer.

For example in below table we can see the percentage of firm shares outstanding owned by the PRC government, private domestic and private foreign owners in the period 1993 to 1997. As we

can see in all years the percentage of government ownership is more than private ownerships. And even today it has not changed significantly. Still government holds the majority of ownership in economy.

Table 3

	1993	1994	1995	1996	1997
Government ownership					
Mean	56.5%	57.3%	56.9%	56.2%	55.5%
Private domestic ownership					
Mean	12%	14.5%	13.4%	13.9%	13.9%
Private foreign ownership					
Mean	31.5%	28.2%	29.7%	29.9%	30.6%
Number of firms	18	38	60	69	83

Source: Taiwan Economic Journal Mainland China Database Data Book, 1998

Prior studies on the different classes of shares indicate that there are significant differences in liquidity and pricing among the different markets. Harding (1998) contrasts the A and B share markets by describing the former as “large and liquid” and the latter as “small and stolid.” There is also a perception that companies listing B shares are generally of lower quality than those with only A shares. While the A-share price index rose by 32 percent in 1997, about half of the 88 firms listing B shares currently sell for less than net asset values or original issue prices (Harding, 1998; Peng and Ziangwei, 1998). Further, after adjusting for currency differences, A shares typically sell for three to five times the prices of B or H shares for the same companies. Arbitrage between the different markets is illegal, but domestic investors with access to foreign currency have purportedly purchased large quantities of B shares, presumably in hopes that the different markets will eventually be consolidated.

3.2.2 Accounting standards in the China

Chinese financial reporting requirements also treat domestic and non-domestic investors differently. Firms listing A shares are required to report under Chinese standards, whereas firms with B shares report using IFRSs, and firms with H shares report under Hong Kong accounting standards or IFRSs. Overall, Chinese Accounting Standards have reflected the methods required for Chinese tax accounting; they have therefore been closer to a cash or tax system of reporting than International Standards. Winkle, Huss and Xi-Zhu (1994) and Chen, Gui and Sui (1999) provide a summary of the Chinese accounting standards adopted in December 1992. They report that while these standards parallel US and international practices in many regards, there are a few notable differences.

First, in valuing assets, PRC standards require strict adherence to historical cost, making no provision for mark to- market or lower-of-cost-or-market. This can have a significant effect on the valuation of inventories, which can be valued at planned prices. Second, the government has stipulated depreciation rates for capital assets and bad debt allowances for receivables (0.3-0.5% of gross receivables) regardless of a firm’s business economics. Third, Chinese standards do not recognize some of the more complex liabilities, such as contingencies, and lease obligations.

Finally, the level of disclosure is often limited. For example, related party sales between listed and holding companies may not be reported, making sales difficult to interpret.

To further complicate financial reporting, domestic and international reports tend to be audited by different audit firms. Domestic reports typically are audited by Chinese auditors that potentially face severe problems in attracting and retaining qualified personnel and maintaining independence. There is a severe shortage of auditing professionals in China. In addition Chinese firms may have difficulty enforcing standards for listed companies that are former SOEs where the government has a strong continuing ownership and an interest in limiting the release of reports that question the performance or viability of these entities. Tefft (1995) reports that both Chinese exchanges are “vexed by company hesitancy to follow corporate disclosure rules and accurate accounting procedures. Only about half the listed firms submit acceptable annual reports.” Xiao, Zhang, and Xie (2000) report that major features of Chinese auditing include “lack of audit independence, the shortage of well-qualified auditors, an environment of extensive corruption, and the existence of many misconceptions about the audit.”

Financial reports prepared under IFRSs are typically audited either by Big Four or large Hong Kong firms. These international firms are less likely to be subject to many of the problems facing local Chinese firms. However, they are unlikely to be immune to shortages in qualified staff and to questionable audit practices in their Chinese offices.

Below there is a list of differences between Chinese accounting standards and IFRSs:

- Under PRC GAAP only single income statement approach is allowed, while under IFRSs enterprises have choice of whether to present income and expense items: in a single statement of comprehensive income or using two statement approach which involves presenting an income statement followed by statement of comprehensive income
- PRC GAAP contains detailed requirements on the format of financial statements and the items to be presented, while IFRSs set out overall principles and minimum line items to be presented.
- The PRC GAAP requires financial year of 1 January – 31 December as financial year, while IFRSs require to present financial statements at least annually, however it does not require specific start and end period.
- Under PRC GAAP expenses should be presented by their function but IFRSs allow enterprises classify expenses either based on nature of expenses or their function.

3.2.3 Other capital market infrastructures in China

Khanna and Palepu (1998 and 2000) argue that a critical challenge in the development of a modern capital market by developing and transitional economies is the creation of effective supporting institutions and infrastructure. These include the financial reporting and auditing standards discussed above. However, they also include markets for second hand assets and valuation expertise, capital market regulations, legal protection of private property, financial intermediaries such as analysts, and the financial press. Not surprisingly, the PRC has only begun to develop many of these institutions and infrastructure. The market for second hand assets and expertise in valuing assets is critical for financial reporting, as well as for the pricing of initial public offers. Prior to going public, SOEs have to prepare financial reports that present data on the historical cost of capital and current assets, as well as estimates of the current value of net assets. However, many assets were acquired at planned prices, not market prices. Prospective issuers obtain independent valuations of their assets for both setting offer prices and for financial reporting. External valuation firms (from Hong Kong and elsewhere) are used in the valuations for international offerings. These valuations can raise sensitive political questions, since the Chinese government is anxious to ensure that stocks sold to international investors are not underpriced. Valuations for domestic issues are typically by Chinese valuation firms.

However, there is a severe shortage of trained professional valuers, making it difficult to assess the quality of these valuations. Responsibility for the regulation of financial markets in China nominally lies with the China Securities Regulatory Commission (CSRC). Since 1995 the commission has reported directly to the State Council, the Chinese government's highest-ranking decision-making authority. Previously, it reported to the Ministry of Finance, the People's Bank of China, and the State Committee for Restructuring the Economy. However, the commission has historically been poorly funded and staffed. The Shanghai municipal government and the Shanghai branch of the People's Bank of China also appear to play an important role in securities regulation. For example, in August 1995, the Shanghai branch of the central bank closed 14 offices of out-of-town brokerages for violating rules on operations of financial institutions.

Another important form of infrastructure for financial reporting and capital markets is legal protection for investors. Securities laws typically protect a number of shareholder rights in developed market economies. These include protections of minority shareholders' rights, restrictions on insider trading, and shareholder rights to vote for boards of directors and to sue management for fraud, misleading disclosures or misappropriation of funds. Investors are likely to have questions about the extent of these forms of protection in China. Since the government is the majority owner of most listed companies, protections of the rights of minority owners are especially relevant. In addition, international investors are likely to have concerns about whether they have the same rights as domestic investors. Winkle, Huss, and Xi-Zhu (1994) cite claims that PRC- and IFRSs-based reports "are often released at different times and contain different levels of information." Typical investor complaints are that A shareholders receive financial information earlier than B shareholders and that A shareholders receive a much broader disclosure of the company's performance (see Winkle, Huss, and Xi-Zhu). A legal system that protects shareholder rights is also important in China because the country's economic system has historically provided job security and expensive benefits to employees and management, as well as funding for loss-making businesses. These policies raise several questions for private investors. First, is it difficult to remove management for good cause? Second, can funds provided by public issues be diverted from their intended uses towards meeting pension obligations or financing loss-making business segments?

Another form of infrastructure that has been created with the development of a capital market is a community of financial analysts. In developed market economies financial analysts provide investment advice and also monitor the performance of management. Management of stocks that are out-of-favor with analysts because of poor performance is then likely to be subject to increased shareholder and board scrutiny or likely to be removed by a hostile acquirer. However, in China analyst coverage is limited. There is some analyst coverage of H shares by Hong Kong investment firms. However, there is relatively low demand for financial analyst services by international investors since the B share market is so thinly traded. Analyst coverage of A shares listed on the Shanghai and Shenzhen Exchanges is also limited. Finally, the financial press in China is likely to play a weak role in monitoring management of public companies. Chinese newspapers provide summaries of financial information on listed companies every six months. However, it is not politically feasible for them to publish articles that criticize managers who, after all, are effectively appointed by the government.

In summary, capital market infrastructure in China is in a formative stage. The types of professional intermediaries and legal rights that have evolved in developed economies are still being created in China.

In the last part of my thesis for China I would like to stress on the fact that as noted earlier, IFRSs are based largely on UK and US accounting standards and enables managers to use business judgment to represent their firms' performance to investors. Academic research indicates that US and UK accounting information is useful to investors, implying that institutions that seek to control managers' use of financial reporting judgment are at least somewhat

effective. Earnings and earnings changes are closely related to stock prices and returns. Further, accruals, which reflect management's reporting judgment, are valued by investors almost as highly as cash flows. However, recent evidence suggests that accounting information is less useful in developing economies. For example, Ball, Robin and Wu (2000) find that, despite the influence of IFRSs, there is low transparency of earnings in China and other South East Asian countries. They argue that low transparency is attributable to weak enforcement of accounting standards in these countries. Several recent studies directly compare the usefulness of IFRSs and local country standards. Harris and Muller (1998) examine the reconciliation between US standards and IFRSs and conclude that market values and returns are more highly correlated with US standards. Leuz (1999) examines how US standards and IFRSs affect stock market liquidity, and concludes that liquidity is enhanced under US standards. Niskanen, Kinnunen, and Kasanen (1994 and 1998) compare accounting data prepared using Finnish standards to that under IFRSs. However, the findings between their two papers are conflicting. Finally, Auer (1996) examines Swiss companies that changed their method of reporting from Swiss standards to either European Community-Directives (EC) or IFRSs. He concludes that both IFRSs and EC earnings provide more information to investors than Swiss data.

Overall, these findings provide weak evidence that IFRSs add value in continental Europe, where there has been a long history of bank financing of corporate enterprise. However, it is unclear whether such benefits also apply to developing or transitional economies, the topic of this paper. Given the lack of accounting and capital market infrastructure in transitional economies, they are particularly likely to face severe problems in monitoring managers' accounting decisions. It is an open question whether such economies are best served by standards that permit managers to exercise financial reporting judgment or by standards that restrict management judgment. China provides a unique opportunity to examine these questions. IFRSs provide Chinese managers with greater opportunity to use judgment in financial reporting than bright-line local rules.

Conclusion

Finally as a consequence of all the information used in the text I can say that today the IFRSs are vital and inevitable which the world countries will be forced to accept either voluntarily or mandatory in the future.

As I talked at the beginning of the chapter the IFRSs have a lot of values on world economy such as political value and economical value. On the other hand IFRSs have many advantages for debt and equity investors. Also IFRSs have positive effects on preparing the financial statements, decision making and management process of company. And moreover today through implementation of IFRSs the Fair Value principle is applied which has a lot of advantages over the historical cost accounting because fair value incorporates more information into the financial statements. As I mentioned above fair value contains more information than historical costs when there is observable market price that managers cannot materially influence or independent, accurate estimate of liquid market prices.

Due to all of these facts today it is quite obvious why there is an international convergence in accounting all around the world.

Voluntary adoption of the IFRSs (IASs) was accelerated in 1990s. The reason for acceleration was related to the need of companies for foreign investment in those years. But however there were some issues between national standards and IASs regarding the transition process. Especially when it came to the priority focus of statements, for example IASs mainly focused on shareholders but German GAAP traditionally focused on stakeholders in preparing the financial statements. But however there were quite large economic consequences of voluntary IASs adoption in countries. Because of adopting IASs reduced information asymmetry between managers and shareholders.

Next stage was mandatory adoption of the IFRSs in European Union. On June 2002 the council of Ministers of EU issued an official statement to require all listed companies to prepare their financial statements according to IFRSs for the fiscal year starting January 1st 2005. But however it was not easy process to apply the mandatory adoption of IFRSs in European countries. There were a lot of obstacles regarding the implementation of IFRSs in that period such as political and legal conservatism. As a political issue we can see the concerns were raised by French government. In time of enforcement of IFRSs adoption in EU, there were some doubts for Fair Value measurement for IAS 39. Especially it caused many suspects to the banking industries. Because under IAS 39, banks must report fair values of the financial instruments and eventually will experience increased volatility in the balance sheets and earnings. The European committee endorsed IASs with carve- out to allow hedging accounting for banks' core deposits, which is forbidden by US GAAP and IAS 39.

On the other hand there were some legal conservatism examples as well. As we know in common law countries consolidation of powers was under the king through the development of judicial system in order to centralize control over courts. But the reason for setting the accounting standards was derived from information demands from investors, not from demands of government.

- Accounting standards in common law countries are mostly set by private organizations such as FASB in US.
- But Code Law, such as in France and Germany, was developed to allow governments to control setting and interpretation of laws. Accounting standards in these countries were therefore primarily influenced by governmental priorities.

But in general no matter of legal system, IFRSs adoption added quite large value to the economy and preparing the financial statements of common law and code law countries.

Then we could see two different big countries - Russia and China - regarding transition period to IFRSs - how the culture and general environment affected the adoption of international standards.

In terms of Russia we could see that although there have been a lot of problems regarding implementation of international standards, during last 20 years there have been quite big achievement in this manner. As we know approximately for 70 years there has been soviet accounting system in Russia. That is why it was not so easy to adapt to the international standards quickly. After the collapse of Soviet Union in 1991, Russian companies felt the need for foreign capital and investment. And it was unacceptable for foreign investors to rely on financial statement prepared based on old soviet accounting system, because there were quite big gap between IASs and RAS. However the Russian government decided slowly to adapt the international standards. Although in 1998 the minister of finance declared the aim of country was to adapt to the international standards by 2000, this target could not be reached. Maybe the process will take one more decade. There are several factors which create obstacles for Russia to adopt the IFRSs fully.

There are several differences between RAS and IFRSs currently, for example there are some differences in application of Fair Value concept, most of financial instruments are accounted for at cost or amortized cost, PPE is not impaired, Deferred tax is calculated using the income statement method, revenue and expenditure are recognized after primary documentation supporting the transaction has been received in accordance with tax rules.

There are particular reasons for these differences. For example the reason for not adopting the standard on financial instruments is related to lack of demand. Very few Russian companies use complex financial instruments. Because this standard is difficult to understand and many accountants are not eager to learn this standard that probably they will never use it in the foreseeable future.

Another issue is related to translation problem. It is not easy to translate all the terminologies into Russian properly. And most of the accountants are unable to use the original version of standards. Because most of the accountants have been educated in old soviet system and can not use English materials. Only in big cities like Moscow, St. Petersburg the accountants are able to use the modern materials in English properly. But in other far destinations it still remains one of the obstacles.

In terms of China it is also fact that today china is trying to reduce the differences between IFRSs and its own GAAP. For this China adopted new PRC GAAP since 1 January 2007. The aim of government was to come closer to IFRSs through this new published GAAP. Although there has been a lot achievement in terms of closing to IFRSs through this new GAAP, still there are differences between these two standards. Briefly we can summarize those differences as follow:

- Under PRC GAAP only single income statement approach is allowed, while under IFRSs enterprises have choice of whether to present income and expense items: in a single statement of comprehensive income or using two statement approach which involves presenting an income statement followed by statement of comprehensive income
- PRC GAAP contains detailed requirements on the format of financial statements and the items to be presented, while IFRSs set out overall principles and minimum line items to be presented.
- The PRC GAAP requires financial year of 1 January – 31 December as financial year, while IFRSs require to present financial statements at least annually, however it does not require specific start and end period.
- Under PRC GAAP expenses should be presented by their function but IFRSs allow enterprises classify expenses either based on nature of expenses or their function.

In conclusion I would like to mention that actually today expansion of IFRSs is bigger than previous decades. There are several reasons for this expansion. One of the main reasons of this is related to the need of companies for foreign investment and capital. At the beginning of 1990s in European area firstly the voluntarily then mandatory adoption process was accelerated through the direction of EU. By this way more or less Europe has achieved some kind of strong convergence in preparation of financial statements despite some political and cultural differences at the beginning. And today the process is going to expand to US and East Asian countries like Japan and China which are playing some kind of giant role in world economy. In this manner there have been a lot of differences and debates to find the solutions for these differences between FASB and IASB. And currently there is an active and uninterrupted correlation between two these independent boards in order to bring together the gap between IFRSs and US GAAP. On the other hand as mentioned above the East Asian countries, Japan and China, are going to adapt to international standards as much as possible in order to integrate to the unified single world accounting standards.

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