# Implementation Challenges in International Accounting Convergence

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# Overview

- Starting point:  intent of having accounting standards
  - Significance of implementations of IFRS for international convergence
  - US SEC proposals to allow IFRS without reconciliation
- A research perspective on characteristics of implementations
  - Not independent of the standards
  - Reflect (or summarize) behaviors (judgments, decisions)
    - Behaviors are difficult to observe
    - Focus on outcome indicators
      - Choosing outcome indicators
- Examples of research on implementations
  - Importance of the European Union adoption of IFRS
- What do we know about implementations?

# Starting point: intent of having standards

- Professional guidance (or standards)
  - Established by a designated authority and therefore accepted
  - Models, rules or specifications
- Intent of having standards: Uniformity of behavior in service of some objective
  - Tax: Collect revenues and (perhaps) affect behavior
  - Auditing: Regulate conduct and affect behavior of group subject to the standards
  - Financial reporting: Create decision useful financial information
- Implementation
  - Performance, completion or carrying out
  - Implementations are *behaviors*
  - Cognitively demanding (requires both knowledge and skills)
- *Inference*: Implementation of professional guidance should *also* be in service of the objective of the standard. Implementations of accounting standards should have the goal of providing decision useful information.

- *Observation*: My discussion presumes that a single set of high quality financial reporting standards, used in all jurisdictions and implemented consistently and rigorously, is a desirable outcome. Not all would agree.

# Significance of IFRS implementations for convergence

- Among large economies, only Japan and the US have not adopted (or announced plans to adopt) IFRS
  - In particular, IFRS as adopted by the European Parliament must be used by listed enterprises in the 27 member states of the European Union
  - Requirement appears to be linked to creation of a single capital market
- The US SEC has proposed permitting a *choice* between US GAAP and IFRS
  - Proposal 1: Choice restricted to non-US firms
  - Proposal 2: Choice permitted for any SEC registrant
  - Certain conditions must be met, per the SEC proposal
    - *Condition 1: A single set of standards*
      - IFRS as promulgated by the IASB, not modified (for example, by a jurisdiction-specific standard setter)
    - *Condition 2: Implementation*
      - Consistent and uniform application
- *Implication*: Implementation of IFRS has implications for the successful creation of a single EU capital market and for the SEC's acceptance of IFRS for use by SEC registrants without reconciliation

# Analysis of condition 1 and condition 2

- Condition 1 implies consistent *use* of IFRS, as promulgated by the IASB
  - Over 100 jurisdictions claim to *use* International Accounting Standards/ International Financial Reporting Standards (IFRS) either as promulgated or otherwise
    - Indicator of use is a statement of conformity in auditor report
  - Some jurisdictions create national standards that are intended to be IFRS-equivalent
    - *Examples:* Australia and New Zealand
  - Some jurisdictions require IFRS for only certain types of entities
    - *Example:* Russia and Kazakhstan require IFRS for financial institutions only
  - Some jurisdictions use standards that are based on or similar to IFRS, with modifications for local jurisdiction conditions
    - *Example*: China's ASBE [Accounting Standard for Business Enterprises] is "substantially in line with" IFRS
- Condition 2 implies *converged financial reporting outcomes*
    - Regardless of jurisdiction, entities that use the same financial reporting standards (IFRS) implement those standards the same way
    - Not only must the standards be the same, but also the implementations
    - Affects financial reporting quality

# Importance of implementation guidance for achieving converged financial reporting outcomes

- Commentators agree that implementation is important but do not agree on the appropriate amount of prescriptive guidance
  - Zhang Wei Guo, former Chief Accountant of the China Securities and Regulatory Commission, currently a member of the IASB, "No matter how high the quality of an accounting standard, there will be not be high quality and comparable accounting information without reasonable and consistent interpretations and strict enforcement."
  - Sir David Tweedie, "The regulators need to understand that they can wreck this [IRFS adoption] by demanding restatements if a company meets the principle by using one method while the regulator prefers another."
  - Tony Good, Chair of the Accounting Advocacy Committee of the UK Society of Investment Professionals, "We may just have to accept that, for example, German interpretations will be different to those in the UK. And just hope that there is not too wide a gap."

# Implementations are one step in financial reporting

- Implementations of financial reporting standards are one step in a process
  - Standards
  - Implementation decisions
  - Auditing
  - Oversight (governance)
  - Enforcement
  - Public scrutiny
- Implementations are shaped by (among other things) expertise, available data and measurement technology, and incentives. They can be characterized as:
  - Conscientious and skilled application
  - Good faith but uninformed or unskilled application
  - Subversive application
  - Willful violation

*Questions to consider:*

- Which characterization of implementations is most empirically descriptive?
  - Does the most empirically descriptive characterization vary by jurisdiction?
- What *should* standard setters assume about implementations?
- What *do* accounting researchers tend to assume about implementations?

# An observation about expertise and incentives

Accounting research often implicitly or explicitly assumes that *only* differences in incentives matter for accounting implementations, or that other effects are second-order and can be safely ignored (i.e., implementers are experts). This assumption may not be correct.

*Example 1:* Kurt Eichenwald, *Conspiracy of Fools*, p. 11: *…[C]rime at Enron…was just one ingredient in the toxic stew that poisoned the company. Shocking incompetence, unjustified arrogance, compromised ethics, and an utter contempt for the market's judgment all played decisive roles. Ultimately, it was Enron's tragedy to be filled with people smart enough to know how to maneuver around the rules, but not wise enough to understand why the rules had been written in the first place* (emphasis added).

*Example 2: Report of the Special Examination of Fannie Mae,* May 2006, emphasizes the adverse consequences of failing to invest the necessary resources in accounting and financial reporting. From p. 238: *The failure to invest adequately led to critical resource shortages and a lack of technical accounting expertise*….(emphasis added)

*Example 3*: General Motors 2006 10K report acknowledges material weaknesses in internal controls over financial reporting. *The Corporation lacked the technical expertise and processes to ensure compliance with SFAS No. 109…..and in certain instances lacked the technical expertise and did not maintain adequate procedures to ensure that the accounting for derivative financial instruments was….appropriate* (emphasis added)

# An observation about complexity

- Complexity of the transaction, of the standard, or of the required measurement probably implies larger confidence intervals around the reported numbers (which are point estimates).
  - *Conjecture*: Width of confidence intervals in reported numbers has increased irretrievably because of the nature of commercial arrangements combined with limitations of available measurement technology. Together, these limit the precision of implementations, but not necessarily their consistency.
  - Various high-level committees and task forces in the US are charged with reducing "complexity in financial reporting" (although there does not appear to be agreement as to how complexity is to be defined and measured, let alone reduced).

*Questions to consider:*

- What is the level of uncertainty of measurement that should result in either a change in the accounting or no accounting at all?
- *A*re some standards particularly difficult to implement and if so, what are the implications for consistency of reporting outcomes? *Examples*: SFAS 133, IAS 39
- What are the implications for education and training of accountants?

# An observation about neutrality

- Non-neutral standards
  - Accounting "subsidies" create incentives for implementations that obtain the subsidy (standard affects implementation)
    - *Examples:* SFAS 13 and IAS 17 (leasing), portions of SFAS 133 that pertain to the "short-cut" method for hedge accounting
  - Conservative standards intended to counteract perceived incentives to overstate assets and income (the standard setter's perceptions about implementation affect the standard)
    - *Examples:* Impairment testing in both IFRS and US GAAP

*Question to consider:*

- In light of well recognized incentives to overstate income and assets and evidence that overstatements occur, should standards be non-neutral (conservatively biased) so as to counteract these incentives for a biased implementation?
- This question speaks to what the standard setter should assume about implementations.

# Summary comment about other elements of the financial reporting process

- Management's implementations take account of and are constrained by:
  - Standards themselves—neutrality, complexity and required knowledge
  - Expertise and available data and measurement technologies
  - Auditing and oversight
  - Enforcement
  - Public scrutiny
- Implementations of certain auditing, tax and financial reporting standards are interrelated
  - *Example*: Auditor's judgment about the financial reporting treatment of an uncertain tax position.

*Observations*:

- Research that focuses on managers' financial reporting incentives controls for these other effects, assumes they do not vary across treatment conditions, or assumes they are second order effects that can be safely disregarded.
- How likely is it that these other elements do not vary across the jurisdictions that apply IFRS?

# From a research perspective, implementations are behaviors

- Potentially observable in experimental settings
  - Capture the judgments and decisions of implementers *directly*
- Not observable in general in archival data
  - *Observation:* In principle, archival records of PCAOB inspections could provide indirect evidence on implementation decisions in the US. I am not aware of an equivalent source of information outside the US.
  - *Observation*: Analyses of discovered frauds provide direct evidence of outcomes of implementation decisions that involve willful violations of reporting standards
- Archival research usually selects *outcome indicators* that are presumed to capture, summarize or reflect implementations
  - Properties of reported numbers
  - Auditor decision to qualify a report
  - Number of segments reported
  - Properties of analysts forecasts
  - Statistical measures of the relation between reported numbers and market variables
- Archival research also selects *correlated indicators* that are presumed to be related to implementations
  - Fees for audit and nonaudit services are viewed as correlated with (or even causing) lack of auditor independence.

# From a research perspective, implementations are behaviors

- Outcome indicators and correlated indicators capture *both* the influence of implementation decisions *and* the influence of other elements of the financial reporting process that are related to (and affect) implementations
  - *Example:* Business or accounting fundamentals.
    - After the researcher controls for fundamentals, the remaining portion of the outcome indicator is presumed to capture the influence of implementation decisions
      - » *Example*: Accruals that are not explained by accounting fundamentals capture earnings management (an outcome indicator)
      - » *Example:* Audit fees that are not explained by business fundamentals capture auditor-client bonding (a correlated indicator)
  - *Example:* Nature of the standard that is being implemented
    - Research typically does not control for the difficulty (or complexity) of implementing the standard

# Choosing outcome indicators

- Choice of outcome indicator dictated by the research question
  - *Example:* Do abnormally large audit fees lead to auditor-client bonding and (therefore) less-rigorous auditing which in turn implies less rigorous implementations?
    - Outcome indicator should capture effects of less-rigorous auditing, presumed to be lower-quality financial reporting
      - *Examples:* Restatements, enforcement actions
      - *Examples: A*bnormal accruals; earnings response coefficients; explanatory power of earnings for returns
    - Test variable is audit fees (predicted to increase with presumed bonding, taken to imply less-than-independent implementation of auditing standards)
    - Research design must control for other effects on the outcome indicator and for other effects on audit fees
      - *Example:* Abnormal audit fees are fees not explained by fundamentals such as size, merger activity, leverage and auditor tenure (e.g., Ashbaugh et al., *The Accounting Review*, 2003).

# Choosing outcome indicators

- Choice of outcome indicator constrained by available data
  - Not possible to observe auditor-client bonding directly
    - Measure bonding as audit fees that are not explained by fundamentals
  - Not possible to observe audit implementation decisions directly
    - However, good (poor) audits should increase (decrease) earnings quality
  - Well known difficulties in this kind of setting
    - Uncontrolled factors that affect the observed relation between an outcome indicator (earnings quality) and the test variable (audit fees)
    - Association between earnings quality and audit fees may be due to auditor-client bonding, failure to control for fundamental determinants of fees and earnings quality, or misstatement of the relation
      - *Example:* High audit fees might be caused by auditors' assessments of higher risk in firms with poorer earnings quality (e.g., Gul, Chen and Tsui, *Contemporary Accounting Research,* 2003), as opposed to higher audit fees being a cause of auditor-client bonding.
    - *Conjecture:* Are audit fees and implementation quality jointly determined (that is, mutually dependent and also driven by many of the same fundamentals)?
      - Size, losses, business model complexity appear as determinants of *both* audit fees *and* accruals quality (Dechow and Dichev, *The Accounting Review,* 2002)

# Choosing outcome indicators

- Choice of outcome indicator affects the answer to the research question
  - An *income-based* measure of accounting quality could decline while other measures increase
    - Income based measures include smoothness (volatility), predictability and persistence
    - Market based measures include earnings response coefficients and explanatory power of earnings for returns
    - Analyst based measures include analyst forecast error, dispersion and bias
  - *Example:* Kohlbeck and Warfield (working paper 2005) examine the influence of four US accounting standards on accounting quality
    - Standards pertain to pensions (SFAS 87), other post-retirement benefits (SFAS 106), investments (SFAS 115) and taxes (SFAS 109)
    - Outcome measures of accounting quality include analyst forecast error and forecast dispersion, earnings persistence, and explanatory power of book values and earnings for prices
    - Results indicate that some measures increase while others decrease or are unchanged
    - Results differ across the four standards examined

# Choosing outcome indicators

*Observation:*

- Research that considers outcome measures as a function of accounting standards makes (implicit) assumptions about implementations, particularly if the standard permits choices.
  - *Example:* SFAS 133 and IAS 39 allow (but do not require) hedge accounting as an income smoothing treatment.
    - Implementations that choose hedge accounting would be expected to affect earnings properties differently from approaches that do not
  - *Example:* SFAS 115 and IAS 39 allow (but do not require) investments to be classified as available-for-sale (AFS), with unrealized changes in fair value excluded from earnings, and realized changes recycled from a shareholders equity account to earnings
    - Classifying investments as AFS (instead of trading) eliminates changes in fair value from *earnings* until the investments are sold.

# Choosing outcome indicators: reported numbers

- What properties of reported numbers are affected by implementations?

  *From the FASB's Conceptual Framework and the IASB's Framework*

  – Reliability (representational faithfulness, verifiability, neutrality)
    - Outcome indicators based on the relation between reported numbers and market variables capture *combined* relevance and reliability
    - Relevance is not much (if at all) affected by implementations

  – Comparability
    - To capture implementation effects on comparability, need a benchmark for implementations that treat similar items similarly
    - *Conjecture:* Do accruals that cannot be explained by accounting fundamentals (presumed to capture the underlying events and transactions) indicate noncomparability?

  *From research*

    - Smoothness, conservatism, persistence, predictability, relation to indicators of economic fundamentals such as cash flows

*Question:* Can properties used in research be linked to properties from the IASB's *Framework* and the FASB's Conceptual Framework?

# Choosing outcome indicators: market based

- Market based outcome indicators are derived from regressions of market variables on accounting variables (or reverse regressions)
  - Valuation multiples (regression coefficients)
  - Explanatory power
- Examples
  - Do fair values and book values of trading securities and AFS securities explain the difference between book value and market value of equity for banks? (Park, et al., *Journal of Accounting, Auditing and Finance,* 1999)
  - Did SFAS 131(segment reporting) affect the stock market's ability to predict future earnings? (Ettredge, et al., *The Accounting Review*, 2005)
  - Do deferred tax liabilities (per SFAS 109) have incremental explanatory power for equity values (compared to APB 11 measures)? (Ayers, *The Accounting Review*, 1998).
  - Do disclosed fair values of financial instruments explain cross-sectional variation in nonfinancial firms' equity values? (Simko, *Journal of Accounting, Auditing and Finance,* 1999)

# Choosing outcome indicators: market based

*Observations about market based outcome indicators:*

Widely used, heavily scrutinized and frequently criticized

Viewed as summarizing many steps in the financial reporting process, beginning with the standards, through investor use of the reported numbers

Capture investor response to the information being tested

Analysis requires assumptions about how investors use information

# Choosing outcome indicators: analyst-forecast based

- Outcome indicators derived from analyst forecasts
  - Accuracy, dispersion, bias, private versus common information
- Settings where analyst forecasts are desirable outcome indicators of implementation decisions
  - *New information:* provision of new information to analysts
    - Regulation FD (Fair Disclosure) in the US
    - Disaggregations that provide new information (e.g., segment disclosures)
    - Recognition standards that provide new information (e.g., other post-retirement benefits)
  - *Changed information:* e.g., change in a measurement attribute
    - *Example:* Shift from amortized cost to fair value for financial instruments
    - Less clearly desirable setting than a "new information" setting
  - *Changed location:* require recognition for items previously disclosed
    - Requires assumptions about analysts' cognitive processes

# Examples of research designs to investigate implementation issues using archival data

- Select a standard which can be implemented in more than one way
  - Examine outcome measures that should differ depending on the method of implementation
  - Can be new (e.g., Reg FD) or existing (free choice per the fair value option in IAS 39; estimates used in pension reporting)
- Select a new standard that shifted implementation expectations
  - *Example:* SFAS 131 (US GAAP) requires segments to be based on the organizational/reporting structure of the entity
- Examine settings where incentives have predictable effects on implementation decisions
  - *Examples:* Much of the research on earnings management
- Test for implementation differences between recognized and disclosed numbers

# An example of implementation in diverse jurisdictions: European Union adoption of IFRS for 2005 reports

- Implementation decisions by managers of thousands of entities in over 20 political jurisdictions that vary greatly in:
  - Laws (securities, taxation, governance)
  - Development of capital markets
  - Wealth
- Entities differ in characteristics that research has shown to affect financial reporting outcomes
  - Size
  - Capital structure, including reliance on public equity markets for capital
  - Governance arrangements
  - Ownership
    - Structure
    - Concentration (including dual class shares)

- *Question to consider:* How do these differences affect the consistency of implementation of IFRS in the European Union?

# Importance of the European Union adoption of IFRS

- Naturally occurring experiment to analyze the *relative importance* of standards versus other effects on financial reporting outcomes
  - Incentives: research on earnings management has documented strong incentive effects
  - Expertise: most evidence is anecdotal
  - Information systems: most evidence is anecdotal
  - Governance: research in the US has documented mixed effects
  - Enforcement: research in the US is mostly anecdotal

*Observation:* Research is likely to focus on outcome indicators of financial reporting quality.

# Importance of the European Union adoption of IFRS

- Analysis of relative importance of standards versus other effects
  - Ideal cross sectional research design: hold standards *and other effects* constant and vary one other effect at a time
  - *Difficulties*:
    - Not possible to change just one effect because each jurisdiction is associated with a systematic cluster of effects
    - Some jurisdictions have few IFRS adoptions and lack a time series of data
  - Ideal time series research design: change standards (adoption of IFRS) while holding *other effects* constant over time
  - *Difficulties*:
    - IFRS implementation likely to be associated with other changes
    - Some jurisdictions lack a time series of data

# Importance of the European Union adoption of IFRS

- Analysis of the importance of enforcement
  - Possible approaches to enforcement
    - No formal enforcement mechanism—rely on auditing
    - Enforcement by stock exchanges
    - Enforcement by a regulator of stock exchanges
    - Enforcement by a separate review panel
    - Enforcement by a governmental body
      - » Inspection of filings
      - » Powers to subpoena; civil versus criminal actions
    - No systematic cross-jurisdictional securities enforcement
      - » CESR (Committee on European Securities Regulators) is intended to improve co-ordination in the European Union

*Question to consider:* Is a single global securities regulator an important condition for converged financial reporting outcomes?

# What do we know about implementations?

- Receive significant attention from preparers, auditors, regulators and standard setters
- Have a discernible effect on reporting outcomes
  - Research on earnings management
    - Loss avoidance, meeting earnings targets, discretionary accruals
  - *Question*: Which has the greater effect on reporting outcomes, the standards or their implementation?
    - Key issue for adoption of IFRS in jurisdictions with widely varying laws, information systems, expertise and enforcement
    - Ball et al., *Journal of Accounting and Economics,* 1999, suggest that implementations swamp standards
  - *Question*: How comparable are implementations within and across jurisdictions?
    - Preliminary analysis of 100 financial reports filed by IFRS users that are SEC registrants
      - Majority asserted compliance with both IFRS and a jurisdictional version of IFRS
      - Variation in several areas of accounting
        - » Certain mergers, recapitalizations, acquisitions of minority interests, consolidation policy
        - » Revenue recognition
        - » Intangible assets
        - » Financial instruments

# What do we know about implementations?

- Why do implementations affect reporting outcomes?
  - Much accounting research focuses on the role of incentives, and documents that incentives appear to affect implementation decisions
  - *Question:* Which incentives matter most?
    - *Example:* Cheng and Warfield (*The Accounting Review*, 2005) document that managers with high equity incentives (from stock based compensation) appear to manage earnings with the intent of increasing share values
    - Other incentives include avoiding loan covenant violations. Under what circumstances would this be a significant incentive?
  - *Question:* Do incentives have greater effects than other factors that affect implementations, such as expertise and information availability?