INTERNATIONAL FINANCIAL REPORTING STANDARDS
REGIONAL POLICY FORUM
SESSION TWO – BACKGROUND PAPER

1. INTRODUCTION

The move towards International Financial Reporting Standards presents many benefits for the region. This paper examines some of those benefits in terms of the benefits to users and preparers of financial statements and the functioning of regional financial markets. This paper also considers the issue of consistent application of IFRS which is necessary to fully realise the benefits of IFRS.

2. BENEFITS FOR PREPARERS AND USERS OF FINANCIAL STATEMENTS

The benefits to users and preparers of financial statements from the adoption of IFRS are widely recognised. A large number of different national standards to some degree imposes a high cost on business. This cost is in the form of a direct compliance cost that arises from the need to meet multiple sets of standards if business operate or raise capital across borders. Through the adoption of IFRS, it will be easier for businesses to expand both within the region and also around the world.

In addition, differing accounting standards around the world increase the cost of capital for companies no matter where they operate. This is because differing accounting standards increase the level of uncertainty for foreign investors because they may not be familiar with the financial reporting framework that governs the preparation of financial statements. By moving to one set of accounting standards, this uncertainty is reduced. Cross border investment decisions are made easier because users are able to make direct comparisons between financial statements of companies. This should increase the level of investor confidence in financial statements and reduce the cost of capital. The net result of this will be greater business activity in the region and a more efficient allocation of resources.

For investors, uniform accounting requirements pave the way for greater international diversification and improved investment returns. Investors will have greater confidence that companies are disclosing information in accordance with a comprehensive and internationally accepted body of standards regardless of where the company is located. In addition, confidence in the integrity of the financial statements should increase through improved auditing and regulation of financial statements. In particular, a single set of accounting standards will enable international audit firms to standardise training and better assure the quality of their work on a global basis. For regulators, the confusion associated with needing to understand various reporting regimes would also be reduced.

3. STABILITY OF FINANCIAL MARKETS

Accounting information plays a crucial role in the healthy functioning of modern market economies. Credit decisions and the allocation of capital depend in part on an assessment of firms' profitability, balance sheet position and related financial data contained in published financial statements. From a financial stability perspective, risk measurement and disclosures which reflect economic substance are important in underpinning market discipline. Accounting data is a key tool for analysis by central banks and regulators.

Instability in the financial system may arise from weakening or failure of significant parts of the financial sector and/or extreme volatility in financial asset prices. While unexpected shocks can never be eliminated, it is possible to minimise their likelihood and the extent of their impact when they occur. A key instrument for achieving these goals is the regular provision to financial markets of timely, economically meaningful information. That implies accounting standards which mirror the economic substance, are applied in a consistent manner across entities and require adequate disclosures.

The importance of adequate financial disclosures by companies for financial markets is now widely recognised. The Financial Stability Forum has identified IFRS as one mechanism relevant to sound, stable and well-functioning financial systems. Consistent with this, a number of studies are finding a positive relationship between the level of disclosure requirements and the development of capital markets. In general, comprehensive disclosure requirements that are adequately enforced give investors the confidence to commit resources to emerging markets. Zhou (2004) found that increased accounting disclosures following the introduction of International Standards on Auditing in China resulted in a significant reduction in the level of information asymmetry in the capital market. La Porta *et al* (1997; 2002) show that countries with strong corporate governance (including transparent financial reporting) have more valuable stock markets, larger numbers of listed securities per capita and a higher rate of initial public offerings relative to countries with weak corporate governance. Accordingly it is argued that corporate governance fosters the expansion of financial markets, facilitates external financing of new firms and improves the efficiency of investment allocation.

3.1 Accounting Standards and the Asian Financial Crisis

The cause of the Asian financial crisis in 1997 and 1998 is still the subject of academic debate (Johnson et al, 1999). However, corporate governance practices have been identified as a factor that may have contributed to making the region potentially vulnerable to a financial crisis and could have exacerbated the crisis once it began (Mitton, 2002). In support of this argument, empirical research has identified significant relationships between corporate governance (including financial reporting and corporate disclosure) and economic performance during the crisis both across countries (in terms of exchange rate and stock market movements) and across individual companies (in terms of share price movement) (Johnson et al, 1999; Mitton, 2002; Baek *et al*, 2002). For example, Baek *et al* (2002) identified that Korean firms that had indicators of higher disclosure quality, higher unaffiliated outside ownership, or were focused (rather than diversified) in their operations performed better than other firms during the financial crisis.

Corporate governance is inter-related with firm ownership structure and is also influenced by cultural factors that vary among jurisdictions (Iu & Batten, 2001; Patrick, 2001). At the time of the crisis, the ownership structure in many Asian countries was dominated by high ownership concentration (which allows owners to also be involved in the management of the company), with debt being the primary source of external financing (Rahman, 1998; Patrick, 2001). The close relationship between ownership and control reduced the demand for timely corporate disclosure. At the time of the crisis, the level of compliance with International Accounting Standards by companies in the Asian region was fairly low (Rahman, 1998).

Some specific areas of concern with regard to corporate disclosure have been identified by commentators (Rahman, 1998). These items include:

- disclosures relating to related-party transactions particularly with regard to borrowings;
- disclosures relating to the level of foreign currency exchange risk that companies were exposed to as a result of debt dominated in foreign currency;
- disclosures relating to the business segments that companies were exposed to (in particular, many companies were heavily exposed to the real estate sector that experienced significant decline at the time of the crisis);
- disclosures relating to the level of contingent liabilities of the parent of a conglomerate, or of a financial institution, for guaranteeing loans taken by entities both related and unrelated to the parent; and
- the recognition of loan-loss provisions by financial institutions with non-performing loans.

It has been argued that if companies had been disclosing their level of risk on an ongoing basis, investors may have been able to voice concerns earlier (Rahman, 1998). In addition, if periodic disclosure of this information had been required, banks and corporations may have exercised a more prudent risk management policy (Rahman, 1998). This may have yielded a more stable investment environment.

Subsequent to the crisis, countries in the region have made significant reforms to improve their corporate governance frameworks (Asian Development Bank, 2000) There is now evidence of increased compliance with International Accounting Standards by companies in the region (Lambert & Lambert, 2003). In many cases, this is in response to changes in the regulatory framework in the countries. For example, in 1998, the Republic of Korea introduced accounting standards and disclosure rules that meet international best practice and to require corporate groups to prepare consolidated financial statements (Park, 1999; Asian Development Bank, 2000). In addition, the Republic of Korea established an independent, private sector accounting standard setting body (Kim, 2001) with a structure and due process similar to that of the IASB. This replaced its prior system of accounting standard setting that was subject to government intervention.

4. INTERPRETATION OF IFRS

There is currently a debate among countries that are adopting IFRS over the issue of interpretations of IFRS. It is generally recognised that in order for the full benefits of

IFRS to be realised there is a need for countries to adopt a consistent approach to applying IFRS.

Currently, the International Financial Reporting Interpretations Committee (IFRIC) is responsible for issuing interpretations of IFRS. The advantage of having one international body responsible for issuing interpretations is that the interpretation will then apply to all countries that have adopted IFRS (assuming all countries adopt the interpretation). This will help to ensure the consistent application of the standards. The disadvantage of having one international body responsible for issuing interpretations the body is less responsive to the needs in individual jurisdictions or regions. In addition, some concerns have been expressed over the ability of IFRIC to resolve issues in a sufficiently timely manner. The IASC Foundation has commenced a review of IFRIC's operations that covers a lot of these issues. In April 2005, the IASC Foundation released a consultative paper on this matter that covered issues including:

- the capacity of IFRIC to produce interpretations;
- the approach to rejecting issues for consideration;
- mechanism for dealing with urgent issues;
- the involvement of national standard setters in the interpretative process; and
- the selection procedures for admission of issues.

The European Union is currently addressing the issue of consistent interpretation of IFRS across the EU. The European Financial Reporting Advisory Group has released a discussion paper which canvases various options for ensuring the consistent application of IFRS in the EU. Overall, the discussion paper does not support the creation of such a body and argues that IFRIC should have sole responsibility for issuing interpretative guidance.

Some countries have established bodies responsible for issuing interpretations of accounting standards, for example, the Urgent Issues Group (UIG) in Australia. The operations of the UIG are currently under review as a result of Australia's decision to adopt IFRS. This process is looking at the relationship between the UIG and IFRIC and whether there is a role for the UIG to issue Australian specific interpretations of IFRS.

There are risks involved with issuing interpretations particularly interpretations that are region or country specific. If significant amounts of interpretations are issued, this may result in IFRS, which are deliberately principles-based standards, being overlaid with interpretations that are generally more rules-based. This will erode some of the benefits of adopting a principles-based set of accounting standards (for example, the ability for the standards to apply in a flexible manner to reflect the economic reality of unforeseen circumstances).

There are also issues associated with individual regions or jurisdictions issuing interpretations of IFRS. Allowing individual jurisdictions or regions to issue interpretations has the advantage of allowing jurisdiction or region specific issues to be addressed. IFRIC is unlikely to respond to such issues. This role for national standard setters was recognised in the IASB draft memorandum of understanding with national standard setters (see background paper 3). However, if a significant number of these interpretations are issued, there is a chance that the application of IFRS in regions or jurisdictions will become materially different from the application of IFRS in other parts of the world. This would significantly erode many of the benefits of adopting a uniform set of accounting standards and is a matter that should be monitored over time.

The issue of interpreting IFRS is yet to be addressed by the Asian region as a whole. Whether a regionally consistent approach to the interpretation of IFRS is desirable and, if so, what steps may be taken to achieve this is a matter worthy of further consideration.

5. CONCLUSION

The Asian region stands to gain significant benefits from the move to International Financial Reporting Standards. These benefits come in the form of more stable financial markets, greater regional trade and more foreign investment into our economies. In order to fully realise these benefits there is a need to ensure that the standards are being consistently applied around the world. Further consideration may be given to issues associated with interpreting IFRS.

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