Paper ID : o21-sgmt **Peer Reviewed** **Open Access**

DOI : https://doi.org/10.26703/JCT.v16i2-14
Archive : https://ideas.repec.org/a/jct/journl/v16y2021i2p77-83.html
http://EconPapers.repec.org/RePEc:jct:journl:v:16:y:2021:i:2:p:77-83

How Economic Systems React to Financial Regulation As a Stimuli: A Comprehensive Analysis Using Different Cases of Economies

Received : 28-7-2021
Revised : 9-8-2021
Revised: 12-8-21
Accepted : 16-8-2021

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Plagiarism: *10%*

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Keywords: *IFRS, International Accounting Standards Board (IASB), GAAP, Financial Reporting Standards*

Classification-JEL : *M4*

How to Cite:
Garg, S. & Thakur, M. (2021). How Economic Systems React to Financial Regulation As a Stimuli: A Comprehensive Analysis Using Different Cases of Economies. Journal of Commerce and Trade (H. Agarwal, Ed.) 16 (2), 77-83.

ABSTRACT

IFRS are a set of guidelines issued by IASB, an independent organisation, it is an ideal reporting standard issued in order to regulate the accounting and the way various countries do that. In this paper we have tried to analyse the economic impact, both at the macro and micro level while we touch across different ideas related to the topic. We have chosen a comprehensive approach and have tried to show how this actually affects all the stakeholders. IFRS remains under intense scrutiny for its effectiveness in different settings. While it continues to have both short run and long run consequences. We have taken two cases of Europe and Latin America, and then we tried to understand the way the US GAAP and IFRS and are different from each other. Our primary aim was to reflect on how different stakeholders react to the changes made in the Financial Accounting Systems in their countries. We have also taken up the case of Italy where we have tried to highlight how the debt is substantiated using IFRS. We offer evidence of economically significant growth in institutional holdings in required IFRS adopters based on annual and quarterly firm-level studies and quarterly country-level tests. In comparison to a benchmark sample of non-adopters, institutional ownership and the number of investors grow after first-time IFRS reporting for mandated IFRS adopters.

1. INTRODUCTION

The International Accounting Standards Board (IASB), an independent organisation situated in London, UK, issues IFRS (International Financial Reporting Standards). They claim to be a set of guidelines that would, in an ideal world, apply equally to financial reporting by public corporations all over the world. The International Accounting Standards Committee (IASC), which was founded in 1973 by the professional accountancy bodies of Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States, issued international standards between 1973 and 2000. The IASC's guidelines were referred to as 'International Accounting Standards' during that time (IAS). This rule-making duty has been taken over by a newly rebuilt IASB since April 2001.' Though the IASB continues to recognise (accept as genuine) the former regulations (IAS) published by the old standard-setter, it now refers to its standards as 'International Financial Reporting Standards' (IFRS) (IASC). The IASB has more funding, staffing, and independence than its predecessor, the IASC. Nonetheless, its attitude and accounting rules have been remarkably consistent over time.'

We offer a number of conclusions that are new to the literature, based on a global sample of 10,852 unique enterprises from 45 countries between 2003 and 2006. First, we show that, after controlling for standard economic determinants of institutional holdings, institutional ownership increases by more than 4% and the number of institutional investors increases by nearly ten for mandatory IFRS adopters compared to non-adopters over the two-year period 2005-2006.

Different analyses based on annual firm-

level, quarterly firm-level, and country-level changes in institutional holdings produce consistent results. Second, we show that the positive IFRS effects on institutional holdings are concentrated among investors whose orientation and styles indicate that they will profit most from higher-quality financial statements. Institutional holdings in required IFRS adopters, for example, have increased dramatically for active investors, but have decreased or remained unchanged for passive investors. Similarly, value and growth investors have far higher IFRS-related holdings than index and income investors. Finally, we show that the IFRS-related gains in institutional holdings are not uniform across nations.

Our findings show that institutional holdings grow for first-time required adopters primarily in nations with the strongest enforcement and reporting incentives, as well as high disparities between local GAAP and IFRS. Various sensitivity tests, such as changing sample definitions and extra control variables, have no effect on inferences.

IFRS is used by about a quarter of the world's central banks, with another quarter looking to it for further advice when their local standards are insufficient. Because central banks have a variety of mandates and types of policy operations, there is a lot of difference in the practise, style, and extent of financial disclosures in both the primary statements and the note disclosures. Central banks, by their very nature, are unique in their jurisdictions, and as a result, they do not always have local practises and precedents to learn from. Despite the fact that the main accounting firms have developed model disclosures for commercial banks, they are frequently insufficient for a central bank.

The use of IFRS by central banks varies depending on the central bank's mandate and the accounting profession's capacity in each jurisdiction. An examination of worldwide practises, such as those used in the preparation of these example statements, may aid in answering issues about the form of the statements and the organisation of the note disclosures. As a result, each central bank that follows the International Financial Reporting Standards (IFRS) has essentially produced its own disclosures, with only limited reference to others. External auditors provided valuable input, but some of it was influenced by the approach taken by the specific auditor's style for commercial banks rather than central banks. Auditors aren't always aware of the distinctions between a commercial bank and a central bank, which serves a different purpose and conducts transactions to achieve its policy goals. This has frequently resulted in an overemphasis of non-essential elements in the context of a central bank, as well as insufficient disclosures on operations or accountabilities particular to the central bank's functions.

2. COST

This article presents preliminary evidence on the costs of mandatory IFRS adoption. We quantify a large and directly observable expense incurred by all organisations by studying the fees incurred by firms for the statutory audit of their financial statements following the implementation of IFRS. The significant heterogeneity in the net benefits of IFRS adoption seen in previous work highlights the need to separate and better understand the costs of harmonisation.

Furthermore, given recent worries expressed by U.S. CEOs about the expenses likely to result from a potential U.S. adoption, this research is important. We estimate a 23 percent rise in the mean level of audit costs in the year of IFRS transition, changing with business size and IFRS exposure, using a complete dataset of all publicly traded Australian companies. We expect an 8% rise in audit costs as a result of the IFRS (i.e., beyond normal yearly fee increases). Further research reveals that the smallest businesses bear a fixed portion of the costs associated with IFRS adoption. As a result, we find that, in comparison to large enterprises, small firms see disproportionately greater increases in audit fees around the adoption of IFRS.

According to a survey of Big 4 accounting firm professional auditors, certain aspects of the new IFRS reporting requirements (e.g., share-based incentive payments, financial instruments including hedge accounting, and impairment of goodwill and other intangible balances) require more effort and expertise from auditors to ensure adequate compliance. We confirm that

the firms with the greatest exposure to these standards incur bigger increases in audit fees in the year of adoption by constructing a firm-specific score of IFRS exposure based on our survey data.

The adoption of IFRS is highlighted in this paper as an example of the expenses associated with a mandatory regime change. Although we recognise that there are likely to be other internal implementation costs greater than audit fees, an analysis of these costs is outside the scope of this study. Given the large economic burden that our findings show, local regulators and the IASB may want to investigate how to minimise the stress on small businesses, similar to how the recently announced IFRS requirements for SMEs were done. Given the SEC's forthcoming judgement on whether to allow a full-scale adoption of IFRS in the United States, current evidence on the costliness of IFRS and the individual elements that are the most costly and disruptive will help future adopters and auditors better design their transition programmes.

3. IMPACT

One of the most major regulation changes in accounting history was the adoption of International Financial Reporting Standards (IFRS) for listed firms in numerous countries throughout the world. Over 100 countries have recently adopted IFRS reporting or have announced plans to do so in the near future, and the Securities and Exchange Commission (SEC) of the United States is considering permitting US companies to prepare financial statements in line with IFRS (SEC [2007]). Regulators believe that using IFRS improves financial statement comparability, boosts business transparency, improves financial reporting quality, and hence benefits investors (e.g., EC Regulation No. 1606/2002). There are economic reasons to be sceptical of these expectations, particularly the premise that just requiring IFRS will make corporate reporting ore useful or comparable. As a result, the onomic percussions of requiring IFRS reporting remain unclear.

We present preliminary findings on the capital-market effects of mandatory IFRS reporting in 26 countries throughout the world in this study. We examine implications on stock market liquidity, cost of equity capital, and business value using a treatment sample of over 3,100 enterprises that are required to adopt IFRS. These market-based structures should take into account, among other things, changes in financial reporting quality and, as a result, improvements in the IFRS mandate. We use four market liquidity proxies, including the fraction of zero returns, the price impact of trades, total trading expenses, and bid-ask spreads, as well as four techniques to calculate the implied cost of equity capital and Tobin's q as a proxy for company equity valuations. Our study is complicated by the fact that, as of a specific date, IFRS must be used by all publicly traded companies in a certain jurisdiction.

Three more sets of findings should be noted while evaluating these results. First, while the findings are robust to numerous sensitivity checks, the magnitude and statistical significance of the documented effects varies significantly depending on the benchmark sample, the length of our sample period, and whether we include firms from IFRS-adopting countries that have not yet switched to IFRS as a benchmark. The wide range of effects demonstrates the difficulty of measuring the economic consequences of a legislative change that affects all enterprises in an economy at the same time. Second, the capital-market implications of mandatory (or forced) adopters are measured against local GAAP benchmark firms that are not required to implement IFRS or have not yet transitioned. Firms that switched to IFRS willingly before the mandate are another category against whom the consequences could be measured. Late voluntary adopters, or enterprises that move to IFRS reporting soon before it becomes mandatory, have favourable liquidity and valuation benefits, according to our findings.

Third, and related to the last point, we look at the cross-sectional heterogeneity in the consequences for required and voluntary adopters in order to learn more about the factors that drive capital market reactions. We demonstrate that capital-market benefits emerge only in nations with very rigorous enforcement regimes and where the institutional environment offers substantial

incentives for enterprises to be transparent for both categories. Market liquidity and business value were broadly unchanged around the mandate in the other IFRS adoption countries.

4. CASE STUDIES

a) Latin America

We show how mandatory adoption of IFRS can help lower the cost of equity and debt in Latin American countries with persistently weak institutional enforcement and investor protection. In contrast to previous literature, the cost of equity results reported in this study are solely based on data provided by analysts, and similar results can also be obtained by calculating the cost of equity using the long-term growth rate to forecast the four-year through five-year-ahead earnings forecasts if they are not available. The findings show that after the required implementation of IFRS in five Latin American nations, the cost of equity decreased. Furthermore, firm-level reporting incentives can have an impact on the cost of equity to some extent.

Finally, we show that the cost of debt has decreased in five Latin American nations after the implementation of IFRS. Overall, Latin American nations with weak institutional systems can gain from the mandated adoption of IFRS, depending on their economic and financial situation.

The consequences of our study for investors, debt holders, regulators, and the IASB are enormous. When investors compare the performance of these firms to that of other foreign firms, it can help them construct portfolios and achieve higher yields. Following the recent economic and political crises that these countries have experienced, lower inflation rates and stronger growth rates, as well as more confidence in public company financial statements, may attract additional investment (Moura & Gupta, 2019). This should benefit these countries in the long run, as recent news indicates that investments in these countries seem optimistic in 2019 and beyond, and that their credit ratings are steady. 24 For debt holders, banks, and other lenders, the findings show that the cost of debt has decreased in the post-IFRS period, implying that lenders will be more confident in giving finance to Latin American businesses. External users want high-quality information in order to maintain their funding operations, thus an increase in funding and reduced interest rates can assist Latin American firms grow and improve their capital markets in the long run. Finally, the findings of this study justify the implementation of the International Financial Reporting Standards (IFRS). This serves as a point of reference for the IASB in promoting the adoption of IFRS in other developing or undeveloped nations that have not yet done so.

Even though we have evidence that mandated adoption of IFRS is helpful in the long run, we recognise some of the difficulties in applying IFRS in emerging economies. Emerging countries have faced difficulties as a result of lax enforcement following the adoption of IFRS as released by the IASB. Countries have had to adjust their national accounting policies to IFRS, which can make comparability difficult (Kvaal &Nobes, 2012; Zeff, 2012). In addition, the standards and the process of converting to IFRS are still in the works. Each country has a varied timetable for passing and issuing new legislation as the IASB publishes corrections or revisions to existing standards.

b) Europe and UK

This study looks at how the European equities market reacted to 16 events related to the introduction of the International Financial Reporting Standards (IFRS) in Europe. The adoption of the International Financial Reporting Standards (IFRS) resulted in a large cross-section of European enterprises with a variety of domestic accounting standards switching to a common set of standards at the same time. The likelihood of IFRS adoption prompted European investors to consider the consequences of anticipated changes in firms' information environments and convergence as a result of the change in financial reporting standards.

As a result, the events leading up to the adoption of the International Financial Reporting Standards (IFRS) in Europe provide an opportunity to assess investors' expectations about the net benefits or net costs of IFRS adoption.

We find that European enterprises with lower pre-adoption information quality and larger pre-adoption information asymmetry

have a marginally positive response. These findings support investors' expectations that IFRS will increase the quality of information available to these companies. Investors expect increases in information quality—including any connected with adoption of the controversial IAS 39—for banks with lower pre-adoption information quality, which we find.

We find an increasingly unfavourable effect for companies based in code law nations, which are more likely to have laxer accounting standards enforcement. Even for enterprises with high-quality pre-adoption information, we find a favourable reaction to IFRS adoption events in terms of predicted convergence advantages. This finding is consistent with investors expecting net advantages associated with convergence from IFRS adoption, to the extent that they expect IFRS implementation to change these firms' information only marginally.

Overall, our findings imply that investors anticipated net gains from IFRS adoption in Europe, such as improved information quality, reduced information asymmetry, stricter standard enforcement, and convergence. We'll have to wait for more research to see if these expectations were met.

Since the 1st of January 2005, all EU-listed firms have been compelled to implement IFRS, and a number of studies have looked into whether the cost of equity capital has decreased as a result. The fact that IFRS has reduced the cost of capital only in nations with strong enforcement regimes is a consistent conclusion. In contrast, despite the importance of financial transparency by corporations in establishing the terms of the debt contract, there is a scarcity of study on the implications of IFRS on debt markets.

Improved disclosure resulting from IFRS accounting's greater quality compared to native GAAP should play a major role in debt financing by allowing contract terms to more accurately reflect economic fundamentals. The principles-based character of the IFRS model, on the other hand, may lead to the notion that corporations are still operating opportunistically in nations with weaker transparency incentives, effectively neutralising the theoretical benefits of mandated IFRS adoption.

This study adds to the body of knowledge in two ways. First, we look at the relationship between debt costs and the implementation of international accounting standards in two different institutional settings: Italy, a typical code law country with a weak outside investor protection system, and the United Kingdom, a common-law country with GAAP comparable to IFRS and strong legal protection for outside investors. This method overcomes the drawbacks of using indices to capture institutional variations between countries. Second, because the methodology we use allows the effect of required IFRS to differ between organisations, it is ideally suited to identifying any effect.

The model reflects the basic goal of the International Financial Reporting Standards, which is that consumers should be able to place more weight on reported performance. Unlike earlier analyses of the impact of compulsory IFRS on the cost of capital, ours does not assume that all companies will experience the same drop in the cost of financing. It's unsurprising that those studies have failed to uncover an IFRS effect in nations where enforcement is lax. In this circumstance, the impact of compulsory IFRS may differ between companies, with some finding that their loan costs are decreased, while others finding that their results are less flattering than under local GAAP.

The required implementation of IFRS has a positive impact on the debt-contracting process in Italy, according to our findings. Interest cover, which is an important indicator of borrower risk, is a factor in the post-IFRS period but not in the pre-IFRS period in explaining the cost of debt. Our research contributes to the small number of studies, such as Gaio and Raposo (2011), that show that credible disclosure is possible even in the face of a weak legal framework. We detect no increasing importance of accounting measures in the post-IFRS period in the United Kingdom. This is in line with the fact that UK GAAP is quite thoroughly enforced and roughly similar to IFRS.

5. IFRS vs US GAAP

Before going into the consequences and specific areas of differences between IFRS and US GAAP, it's important to note that the two sets of standards have a lot in common, and they've

become a lot more comparable over time thanks to the (official and informal) convergence efforts of both standard setters. Despite their similarities, there are some significant variances between the two sets of regulations when it comes to specific transactions. There are differences in how individual things are recognised, assessed, and displayed on financial statements, as well as what disclosures are required. The Big Four audit companies keep up-to-date listings of the discrepancies between the two standards, which include several differences. 37 FIN 48 (Income Taxes) and FAS 123R (Share-based Payments), for example, account for several of the significant discrepancies between U.S. GAAP and IFRS, according to PwC (2008).

Furthermore, US GAAP has a layer of particular instructions for businesses. Plumlee and Plumlee (2008) examine a sample of 100 international private issuers that filed a 20-F with the SEC in 2006 and used IFRS in an attempt to assess the extent and direction of the accounting discrepancies between the two sets of standards. Only a few types of significant reconciling items are identified in their investigation. Pensions and post-retirement benefits, share-based compensation, revaluations of property, plant, and equipment, impairment losses on goodwill and intangibles, and deferred taxes are among the areas where impairment losses on goodwill and intangibles have occurred. While net income differences between IFRS and U.S. GAAP (netting across all reconciling items for a firm) are on average small and concentrated (for more than half of the firms, differences fall within +/- 15% of IFRS net income), there are extreme cases with major differences ranging from -206 percent to +253 percent of IFRS net income. The net difference in stockholders' equity is on average 10% (median = 2.7%), with a similar distribution as the net income difference. Similarly, Gordon et al. (2008) look at 20-F reconciliation amounts for cross-listed corporations in the United States that use IFRS as their home-country GAAP and find that business combinations, remuneration, taxes, intangibles, and debt categorization are the five categories with the most discrepancies. Plumlee and Plumlee (2008) show that 75% of international private issuers report IFRS net income in excess of US GAAP net income. 38 The directional effect on stockholders' equity is less clear: just 43% of enterprises report IFRS values exceeding shareholders' equity under US GAAP. The average difference in stockholders' equity, whether positive or negative, is significant (i.e., +35.1 percent and -23.7 percent, respectively), and varies by firm size and industry.

As a result, the impact of switching from US GAAP to IFRS on important indicators like net income, EPS, and stockholders' equity is impossible to forecast for any given company. Furthermore, while 20-F reconciliations give helpful descriptive evidence on the extent and direction of variances between IFRS and US GAAP, the findings are unlikely to generalise to the entire population of US corporations and should so be regarded with caution. Foreign companies with cross-listings in the United States are not reflective of the ordinary American company. Typically, cross-listed companies are major global corporations (e.g., Lang et al., 2003). Furthermore, cross-listed companies may be motivated to reduce or even eliminate reconciliations (e.g., Leuz, 2006).

However, the significance of accounting standards for the integrity of reported accounting figures is frequently exaggerated, and the discussion over IFRS adoption in the United States frequently wrongly focuses on minor differences in the standards. Instead, it's critical to emphasise the justification for reporting incentives. For example, if a company is obliged to move from US GAAP to IFRS but does not want to modify the valuation of a specific asset, managers can try to use reporting discretion to reach the same IFRS valuation. If this isn't practicable (for example, because the asset isn't recognised under IFRS), managers can compensate for the discrepancy in recognition or valuation in other assets by utilising reporting discretion in other assets. Finally, managers can always supply additional information in the form of footnotes, such as a reconciliation timetable. While such extra disclosures are costly, they do limit the scope of the investigation.

Even if accounting variations between IFRS and US GAAP are unlikely to have a significant impact on reporting quality, they can obstruct comparability and cost consumers of financial statements. They may also have mechanical

consequences on contractual provisions, necessitating contract modifications. Finally, accounting inconsistencies may have an impact on real-world operations, investments, and financing. Firms may, for example, restructure transactions after they no longer receive the favoured accounting treatment.

As a result, we present various examples of important accounting discrepancies between US GAAP and IFRS, as well as their possible influence on real-world business decisions. It's worth noting that as the IASB-FASB convergence effort progresses, these disparities are anticipated to narrow. As a result, the relevant differences in accounting standards are those in effect at the planned transition date, not those based on current IFRS and US GAAP.

6. CONCLUSION

To conclude we have journeyed from understanding what is IFRS to its cost and impact. We have taken two cases of Europe and Latin America, and then we tried to understand the way the US GAAP and IFRS and are different from each other. Our primary aim was to reflect on how different stakeholders react to the changes made in the Financial Accounting Systems in their countries. We have also taken up the case of Italy where we have tried to highlight how the debt is substantiated using IFRS.

We offer evidence of economically significant growth in institutional holdings in required IFRS adopters based on annual and quarterly firm-level studies and quarterly country-level tests. In comparison to a benchmark sample of non-adopters, institutional ownership and the number of investors grow after first-time IFRS reporting for mandated IFRS adopters. We also show that growth in institutional ownership is concentrated among investors whose investment orientation and styles place a greater emphasis on financial statement data. This gives us more confidence that the holdings effect we see is due to a change in the financial reporting regime, rather than changes in unmodeled factors that could influence institutional investment. We go on to show that the favourable impact of mandated IFRS adoption on institutional holdings is limited to nations with strong enforcement and reporting incentives, as well as considerable divergence between local accounting standards and IFRS. ●

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