Research Proposal

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By

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Effects to Net Income and Equity of Transition to IFRS:

Will United States Mirror European Union?

I. INTRODUCTION

It has long been the desire of most international equity markets to have a standardized set of guidelines for preparation of financial statements. For decades, every country has had unique national standards. In 2005, the publically traded firms within the European Union (EU) were mandated to utilize International Financial Reporting Standards (IFRS). Initial studies of the transition found significant differences in key items on the financial statements when comparing their country’s Generally Accepted Accounting Principles (GAAP) with IFRS (Haller, Ernstberger & Froschhammer, 2009; Callao, Jarne and Lainez, 2007). Publically traded companies within the United States are not required to report results based on IFRS. Therefore, the question arises whether or not companies within the United States will have the same differences in the same key items as a result of conversion as companies within the European Union. This study utilizes a case study approach to compare pro forma Statements of Consolidated Financial Position and Statements of Continuing Operations under IFRS guidelines for Ford, Bank of America, Ready Mix USA, Dow Chemical, Abbott Laboratories, Castle Brands, and Verizon Communications, with Statements of Consolidated Financial Position and Statements of Continuing Operations of seven European Union companies in similar industries; Volvo, Allied Irish Banks, LaFarge Roofing, Akzo Novel, Sancfi-Synthelabo, Diageo plc, and Deutsche Telekom. Items of interest are reported net income and total equity. It is hypothesized that net income and equity will report significant differences under IFRS from what was reported
under U.S. GAAP for all firms. This is important since management, regulators, and the financial world could expect a shock to earnings per share in the year of transition. For banks, a shift in the amount of equity could have considerable implications for meeting reserve requirements. Moving averages of financial information might be impacted substantially. Share prices could be artificially influenced. Educators need to determine the depth and breadth of IFRS instruction within accounting and finance courses. These are just a few of the potential results of a transition from U.S. GAAP to IFRS.

The remainder of this paper is divided into the following sections: Section II, background material and hypothesis development; Section III, description of methodology; Section IV, presentation of results and acknowledgment of limitations; Section V, conclusion.

II. BACKGROUND AND HYPOTHESES

With the strengthening of the global economy, the demand for comparability of financial statements has increased (Sutton, 1993). Bernardi (2010) and Carlino (2010) both state that the transition from national GAAP to IFRS is inevitable. Many European firms began voluntarily transitioning to IFRS in the late 1990s in anticipation of the announcement by the International Accounting Standards Board that “all publically traded European companies (including those in Germany) are required to prepare their consolidated financial statements in accordance with IFRS for accounting periods beginning on or after 01.01.2005” (Haller, et al, 2009, p. 236). In the 2009 study by Perumpral, Evans, Agarway, and Amenkhienan, it was reported that as of “March 2007, the Press Trust of India reported that India had adopted only 21 IAS (International Accounting Standards) in comparison to 47 IAS adopted by several developed countries” (Press Trust of India as quoted in Perumpral, Evans, Agarwal & Amenkhienan, 2009,
p. 110). However, Perumpral, et al, also reported India’s planned complete convergence with IFRS “on or after April 1, 2011” (Perumpral, et al, 2009, p. 110).

While adoption of IFRS within the European Union countries was mandated as of January 1, 2005, the United States has been slow to adopt IFRS for several reasons. One reason given is that GAAP is known as a “rules-based” system while IFRS is known as a “principle-based” approach. Conformity with the “rules” is believed to enhance comparability of financial statements. On the other hand, a “principle-based” approach “does not address every controversial issue at hand but keep(s) considerable ambiguity about such major processes as record keeping and measurement” (Carmona & Trombetta, 2008, p. 456). However, recent announcements by the Securities and Exchange Commission (SEC) reveal stronger commitment toward a timeline to phase out U.S. GAAP and replace them with the IFRS in the near future. Management, regulators, and stockholders are naturally keenly interested in the impact of this transition on the information that is disclosed in the financial statements.

Several studies examined the impact of the switching from local accounting standards to IFRS on the information reported in the financial statements. Equity and net income were found to be higher when reported under IFRS in the study by Haller, et al. Callao, Jarne and Lainez (2007) also found that equity and net income were significantly different between the two methods in their study of the transition in Spain. The key areas that produced the differences in total equity were due to calculating post-employment benefit obligations (Haller, et al., 2009) and direct adjustments and the indirect effect of adjustment to results (Callao, et al., 2007). Differences in net income were attributed to IFRS 3, business combinations (Haller, et al. 2009) and treatment of research and development expenses, asset impairment, and extraordinary income (Callao, et al., 2007). Prather-Kinsey and Shelton (2005) used level of discretionary
accruals as a measure of earnings management and therefore a measure of the quality of disclosure in the countries of South Africa, United Kingdom, and United States. The purpose of their study was to demonstrate that institutional factors and market forces are key factors to the quality of disclosure of IFRS and U.S. GAAP. They found that discretionary accruals were higher in South Africa than in the United States and lower in the United Kingdom than in the United States implying that the quality of financial information reported is highly sensitive to institutional factors and market forces.

It is hypothesized that net income and total equity of seven case firms and seven reference firms will be higher under IFRS than under U.S. GAAP. It is also hypothesized that, within an industry, the change in net income and total equity reported under IFRS will not be significantly different.

H₁: Each company within the case group will report higher net income and total equity under IFRS than under U.S. GAAP.

H₂: Each company within the reference group will report higher net income and total equity under IFRS than under U.S. GAAP.

H₃: The difference in net income and total equity under IFRS will be the same for companies within the same industry.

III. METHODOLOGY

To date, examinations of U.S. GAAP to IFRS have been conducted on the financial statements of firms headquartered outside the United States. To extend this research into the United States, a case study of seven companies was chosen to examine the differences in net
income and total equity reported on Statements of Consolidated Financial Position and Statements of Continuing Operations prepared under IFRS rather than U.S. GAAP. The case study method was selected as the methodology for this paper in order to assess the direction and magnitude of these differences. Case studies, as defined in social science research, are qualitative in nature requiring rich descriptions of issues and problems based on information gained from various sources (Creswell, 1998 and 2003; Eisenhardt, 1989; Stake, 1995). These sources can include interviews, focus groups, observations, and journals. Data gleaned from these sources is analyzed for themes to describe the experience or situation or insights toward creating or substantiating a theory. Business research has adopted the case study method also. Eisenhardt (1989) has written extensively on the use of case study in management research, particularly in the area of theory building. She asserts “one strength of theory building from cases is its likelihood of generating novel theory” (Eisenhardt, 1989, p. 546). Lukka and Kasanen (1995) support the use of case studies and qualitative research in general in accounting literature.

The seven United States companies selected as the cases were; Ford Motor Company, automotive industry; Bank of America, banking; Ready Mix USA, cement; Dow Chemical, industrials; Abbott Laboratories, pharmaceuticals; Castle Brands, spirits; and Verizon Communications, telecommunications. These companies were selected to match a group of financial statements that have already been converted to IRFS by Deloitte, LLP. Deloitte provided the financial statements in both U.S. GAAP and IFRS for representative companies in seven industries; automotive, banking, cement, industrial, pharmaceuticals, spirits, and telecommunications. The companies are Volvo*, Allied Irish Banks, LaFarge Roofing, Akzo Nobel, Sanofi-Synthelabo, Diageo plc, and Deutsche Telekom. These companies are all
headquartered outside the United States and the statements were from 2003-2004. They will be referred to as the reference group in this study.

Differences in net income and total equity reported under the various local GAAPs and U.S. GAAP will be considered and described to add further background support. It is predicted that results under U.S. GAAP will report more conservatively than other local GAAP. This is due to the “rules based” structure of U.S. GAAP.

The first two hypotheses will be tested in the following manner. Statements of Consolidated Financial Position and Statements of Consolidated Operations for 2003-2004 that were reported in U.S. GAAP for the case companies will be converted to IFRS. Monetary differences in net income and total equity will be recorded for each company. Monetary differences in net income and total equity will also be recorded for each company in the reference group. A $t$-test and non-parametric Wilcoxon signed-rank test will be used to check for statistical significance.

The third hypothesis will be tested by first separating the monetary differences in net income and total equity by firms within an industry. Then a $t$-test will be conducted to determine if the differences between the case group firm and the reference group firm for a particular industry are significantly different.

IV. RESULTS AND LIMITATIONS

Specific results are unavailable at this time. Validation of the results will result by triangulating the direction and magnitude of the differences in net income and total equity of the case group firms, the reference group firms, and the results of the Haller study (see Figure 1).
A major limitation of this study results from the researcher making the decisions of how to apply IFRS standards in the conversion of the financial statements of the case group. In practice, decisions related to the application of IRFS standards would be made by a member of the company’s management. The results of this study will be biased by the choice of the researcher. Another limitation relates to the choice of industries and companies to be analyzed. Selection of the industries and companies within the reference group was determined by Deloitte, Inc. The companies within the sample group were selectively chosen by the researcher rather than through random selection. The industries selected are a very narrow slice of the overall economy. Important segments of the overall market, such as technology, were omitted. Other segments could have significantly impacted the index values.

If triangulation of the results of the study is achieved, one area for future research would be to increase the number of cases analyzed to determine broad trends. To aid future research related to ratio analysis and industry comparability, the financial statements of several of these companies’ other competitors could also be converted to IFRS, ratios computed under GAAP.
and IFRS, and results compared to forecast the potential change in stock price and/or possible management or investor decision-making related to this new information. In addition, the study could be furthered by conducting interviews with representatives from the case group firms and the reference group firms and explore management’s reaction to knowing the direction and magnitude of changes to reported net income and total equity from the transition to IFRS. Last, the current study could be expanded to the time frame 2006-2010 in order to assess the impact of the economic downturn. It is possible the point of conversion within an economic cycle could be a more significant factor in stock price change than conversion of financial statements.

V. CONCLUSION

Regulators are still uncertain as to a date for IFRS adoption or convergence. Convergence appears inevitable, yet the delays cause uncertainty within the equity markets and for management, regulators, and finance and accounting practitioners and educators. In the equity markets any type of uncertainty enhances volatility. Volatility influences valuation creating issues for security analysts and investors resulting in potentially higher capital costs. Potentially higher capital costs could affect management’s decisions as to timing of capital procurement. In addition, licensing bodies are unable to make definitive statements about the extent of IFRS content within examinations. According to the American Institute of Certified Public Accountants (AICPA), effective January 1, 2011, “IFRS may be tested in more than one CPA examination section” and in “more than one question format” (AICPA FAQs). Therefore, accounting practitioners and educators are aware that further education is required in this area, yet remain tentative about committing large amounts of physical and financial resources until the depth and breadth of required IFRS education is more definitive.
This research will either validate the findings of Haller, et al., and Calleo, et al., or provide evidence that United States firms utilizing U.S. GAAP will not experience the same degree of difference in net income and equity as their European counterparts. Either way, markets will be able to anticipate the effect of the move to IFRS and thereby minimize related volatility. Armed with the knowledge of the magnitude of change in reported operating results under U.S. GAAP and IFRS, management, regulators, and the financial world could anticipate any shock to earnings per share in the year of adoption/transition. A simple accounting procedure change is normally unrelated to valuation unless there is some sort of additional informational value in the new approach. According to Daske, Hail, Leuz, and Verdi (2008), adopting IFRS can lower a firm’s cost of capital and increase equity valuations if the firm is operating in a country with strong regulatory enforcement and transparency objectives. This phenomenon was observed for voluntary adopters both when the firms opted to adopt before the mandatory adoption date and again at the time of mandatory adoption by all publically traded firms.

Any new accounting standard or requirement will change the results reported on the financial statements. It is the matter of magnitude and direction of the change that causes unease in the minds of all stakeholders; management, investors, regulators, and finance and accounting practitioners and educators. For bank management, in particular, being able to foresee the direction of a change to equity facilitates meeting reserve requirements and shapes asset management policy. Investors and finance practitioners would like to anticipate earnings per share as a key component of valuation. If uninformed investors react negatively to a change in reported earnings per share that is based solely on an accounting standard, then the firm’s shares could be unduly punished in the market. Regulators are concerned about maintaining
transparency and accuracy. Finance and accounting educators need to understand the implications of the new accounting standards and prepare students to assess what will be unique in the input and output of financial information as a result. Large accounting firms desire students who are already trained in IFRS. This study will enlarge the body of knowledge surrounding the outcomes of converting from U.S. GAAP to IFRS and assist stakeholders in making pertinent decisions.

*During the period of 2003-2004, Ford Motor Company owned Volvo Auto brand. The remaining brands of Volvo were independent of Ford.*
Works Cited


Note: Journal of International Accounting Research has been identified as possible outlet. Call for papers is October 15, 2010, with a theme of “IFRS Convergence and Adoption: Challenges and Opportunities.” This paper is formatted to meet their requirements.