



# International financial reporting standards: an indicator of high quality?

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## Abstract

**Purpose** – The purpose of this paper is to examine the academic literature on the quality of International Financial Reporting Standards (IFRS), formerly International Accounting Standards (IAS), which are poised to be the universal accounting language to be adopted by all companies regardless of their place of domicile.

**Design/methodology/approach** – The methodology used in this study is archival. The authors evaluate the academic empirical literature on the quality of IFRS.

**Findings** – With the world's capital markets becoming more and more inextricably linked, we believe IFRS represents a single set of high-quality, globally accepted accounting standards that has the potential to significantly improve financial reporting comparability among companies on a worldwide basis.

**Originality/value** – It will be difficult to find any time in recent history when financial reporting has been catapulted to such enormous prominence. Some would argue that better reporting would have played a vital role in preventing the complete collapse of the world's financial system. This paper provides valuable input to the US Securities and Exchange Commission, which has recently completed a roadmap, creating the potential for all US public companies to be required to file their financial statements in accordance with IFRS by 2014.

**Keywords** Quality, International financial institutions, International accounting, Accounting standards, United States of America

**Paper type** Research paper

## Introduction

Amidst the economic turmoil that is now rapaciously devouring the world's financial system, it is noteworthy that the British Prime Minister, Gordon Brown (2008), in a recent address to the United Nations, stated that “transparency and improved accounting standards,” adapted by all nations, will be critical to ending a culture of irresponsibility. It is hard to remember any time in recent history when a complete overhaul of our accounting system was considered to be one of the cardinal solutions in preventing a complete collapse of the global economy. In this paper, we examine the academic literature on the quality of International Financial Reporting Standards (IFRS), formerly International Accounting Standards (IAS), which are poised to be the universal accounting language to be adopted by all companies irrespective of their place of domicile[1].

IFRS, overwhelmingly touted as more “principles-based” rather than “rules-based,” is a body of accounting standards developed by the International Accounting Standards Board (IASB). IASB is an independent standard setting body housed in London. Today more than 160 countries have either mandated or permitted the use of



IFRS by publicly traded companies or are in the process of adopting these standards. IFRS has now provided the common platform for all domestic listings in the European Union (EU). In Canada, those charged with setting accounting standards have concluded that it was time for Canadian public companies to adopt globally accepted high quality accounting standards by converging Canadian Generally Accepted Accounting Principles (GAAP) with IFRS over a transitional period. After this transition period Canadian GAAP would cease to exist as a basis of financial reporting for public companies.

Noting the increased globalization of capital markets, Australia has made the decision to adopt IFRS to ensure consistency and comparability of Australian financial reporting with financial reporting across global financial markets. In late 2008, the US SEC (hereafter, SEC), perhaps weary of being viewed as the major obstacle to global accounting standards, issued a roadmap, creating the potential for all US public companies to be required to file their financial statements in accordance with IFRS by 2014. The SEC (2008) further notes that “When the Commission considers mandating use of IFRS by US issuers in 2011, it would consider whether those accounting standards are of high quality and sufficiently comprehensive.”

Motivation for our paper stems from the widespread acceptance of IFRS as a body of high quality accounting standards by major countries in the world, and the increased prominence given to firms’ financial reporting practices in solving the recent global economic crisis. Indeed, the increased globalization and integration of economic activity that have taken place in recent years indicate that the financial health of our global capital markets is heavily dependent on transparent, comparable, and consistent financial information. Clearly, if investors are going to make optimal investment decisions, and companies are going to acquire capital at its cheapest cost, high quality accounting information is a *sine qua non*.

In 2007, the SEC voted to accept financial statements of foreign-private issuers prepared in accordance with IFRS as published by the International Accounting Standards Board (IASB) without reconciliation to US GAAP (SEC, 2007). Prior to this decision, foreign-private issuers were required by the SEC to reconcile earnings and stockholders’ equity based on foreign generally accepted accounting principles (GAAP) to the amounts based on US GAAP in the firms’ annual 20-F reports. It is noteworthy that the Financial Reporting Policy Committee of the American Accounting Association (AAA, 2008) and the Financial Accounting Standards Committee also of the American Accounting Association (AAA, 2008) – the academic arm of the US accounting profession, in recent studies reached dissimilar conclusions on the value to investors of 20-F reconciliations.

In a more recent move, it appears that within the next three to five years the SEC (2008) will move to a mandatory adoption of IFRS by all US public companies. According to its proposed roadmap, the SEC may begin allowing certain companies in specific industries to file their financial statements using IFRS instead of US GAAP as early as 2010, and they may require US public companies to file using IFRS by 2014. The SEC (2008) believes “that the benefits of moving towards a single set of globally accepted standards as a long-term objective for increased comparability of financial statements are attainable through the use of IFRS only if IFRS represents a single set of high-quality accounting standards, which is best accomplished through the use of IFRS as issued by the IASB.” Thus, our paper is also motivated by the current policy

debate on whether the SEC should require US listed companies (both foreign and domestic) to prepare their financial statements under IFRS by 2014, as well as the increased foreign listings in the United States over the past decade.

### **IASC role in harmonizing accounting standards**

Efforts to achieve a global set of accounting standards began even before 1973 when the International Accounting Standards Committee (IASC), the predecessor to the International Accounting Standards Board, was formed. As the volume of cross-border financial transactions increased rapidly in the late 1980s and 1990s, efforts to harmonize international accounting standards gained increasing impetus. The IASC, which was the result of an agreement between the professional accounting organizations of ten countries, has as its stated objectives to:

- (1) formulate and publish accounting standards that can be used in the presentation of financial statements; and
- (2) work for the improvement and harmonization of accounting standards and procedures relating to the presentation of financial statements.

Until the mid-1990s, the IASC did not have any meaningful relationship with national accounting standard setters from such major industrialized countries as the US and UK – countries which have numerous foreign listings on their exchanges and are also known for producing high-quality, transparent and comparable information. Thus, turf wars arose among professional accounting bodies, national standard setters, G4 countries and the Anglo-American bloc that prevented the IASC from making more progress in the development of a universal accounting language (Jacob and Madu, 2004). Moreover, the IASC because of its very structure and membership composition lacked the basic requirements of a global standard setting organization, which were: technical expertise, independence of its members, and representativeness of the decision making body.

The process of setting International Accounting Standards (IAS), now International Financial Reporting Standards (IFRS), has undergone substantial transformation, culminating in 2001 with a restructuring of the IASC into the IASB. Within this new structure, IASB is an independent organization with two main bodies – a 19-member board of trustees and a 14-member standards-setting board. Additionally, there is a Standard Interpretations Committee (SIC) and a Standards Advisory Council.

The rapid globalization of business and finance and the clarion call from investors for a high quality universal accounting language led to the signing of the Norwalk Agreement between the US Financial Accounting Standards Board (FASB) and IASB in 2002 (FASB, 2002). In the Norwalk agreement, both FASB and the IASB recognized their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. Specifically, both FASB and the IASB pledged to use their best efforts in making their existing financial reporting standards “fully compatible as is practicable and to coordinate their future work programmes to ensure that once achieved compatibility is maintained.” At their meeting in October 2005, both FASB and IASB reaffirmed their commitment to the convergence of US GAAP and IFRS.

In a 2006 Memorandum of Understanding (MOU), the FASB (2006) and IASB reiterated that a common set of high-quality global accounting standards remains the

long-term strategic priority of both the FASB and the IASB. As part of this commitment, the IASB and the FASB set out a work plan to converge US GAAP and IFRS on a best efforts basis.

### IFRS movement in the USA

Prior to 2008, a foreign registrant was required by the SEC to file a Form 20-F, analogous to a Form 10-K, within six months after the fiscal year-end. In a Form-20F, a foreign registrant can choose either IFRS/IAS or foreign GAAP, but must reconcile its earnings and stockholders' equity, based on foreign generally accepted accounting principles to the amounts based on US GAAP. This earlier SEC requirement for reconciliation ensured that financial statements prepared by foreign issuers were comparable to those of domestic issuers and sufficiently transparent for investors to make informed decisions. By requiring this reconciliation, the SEC was clearly saying to users of financial statements that US accounting standards and disclosures were not only superior to any other country's standards, but also superior to the standards produced by an international body such as the International Accounting Standards Board.

Essentially, the SEC believes that the cornerstone principle that underpins the smooth and efficient functioning of capital markets is transparent, consistent, comparable, relevant and reliable financial information. In a Concept Release, the SEC (2000) notes, "Establishing and maintaining high quality accounting standards are critical to the US approach to regulation of capital markets, which depends on providing high quality information to facilitate informed investment decisions."

On July 13, 2007, the SEC released a proposal to accept financial statements prepared in accordance with IFRS from foreign-private issuers without reconciliation to US GAAP[2]. On November 15, 2007, the SEC voted in favor of the proposal to dispense with reconciliations for the subset of foreign private issuers that prepare their financial statements in accordance with IFRS. By dispensing with 20-F reconciliation for foreign listees in the USA, who file their financial statements based on IFRS, the SEC is informing US investors that IFRS represents a single set of high-quality accounting standards and is as informative and useful as financial reports prepared under current US GAAP.

In November 2008, the SEC noting the growing level of foreign investments by US residents in international investment opportunities issued a Roadmap, which, if certain milestones are achieved, could lead to the eventual use of IFRS by US issuers. In this Roadmap, the SEC (2008) asserts that it is:

... seeking to realize the objective of providing investors with financial information from US issuers under a set of high-quality globally accepted accounting standards, which would enable US investors to better compare financial information of US issuers and competing international investment opportunities. This Roadmap is further intended to encourage market participants to consider the effect of IFRS in our capital markets and to prepare for the use of IFRS financial statements by US issuers in their filings with the Commission (SEC, 2008).

The SEC further anticipates that providing the alternative to US issuers to file IFRS financial statements would not only broaden the awareness and attention given to IFRS as a single set of high-quality globally accepted accounting standards, but would also enhance comparability of financial reports across the globe. This Roadmap contemplates that the Commission would make a decision in 2011 with regard to the mandated use of IFRS for US issuers.

Clearly, the recent moves by the SEC suggest that IFRS represents a single set of high-quality, globally-accepted accounting standards that has the potential to improve financial statements comparability among companies regardless of their place of domicile. Before turning to an examination of the quality of IFRS as depicted in the academic literature, it is interesting to note that the Financial Reporting Policy Committee of the American Accounting Association (AAA, 2008), the academic arm of the US accounting profession, in an article entitled "Response to the SEC Release, 'Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to US GAAP File No. S7-13-07,'" concludes, after reviewing the academic literature, that it "does not support the SEC's decision to eliminate the US GAAP-IFRS reconciliation requirement for foreign-private issuers." This committee further opines that "The research on the US GAAP-IFRS reconciliation suggests that material differences between IFRS and US GAAP exist and that information contained in the reconciliations is reflected in investment decisions made by US investors."

### The quality of IFRS

As can be seen from the above discussion, the quality of IFRS is of utmost importance to the SEC if it is going to accept financial statements of foreign-private issuers prepared in accordance with IFRS without reconciliation to US GAAP. Will accounting amounts reported under IFRS be comparable to those reported under US GAAP and sufficiently transparent for investors to make informed decisions? This indeed is an extremely complex question to answer since the application of any set of accounting standards exhibits the effects of features of the financial reporting system, including standards, their interpretation, enforcement, and litigation (Barth *et al.*, 2007).

Clearly enforcement, litigation, the accounting education system, and other environmental factors affect the incentives and competence of preparers, auditors, and users of financial reports. Nonetheless, with some difficulty as discussed below, some researchers have tried to isolate the effects of accounting standards on financial reporting quality, holding constant several of the aforementioned environmental factors. Over the years, several streams of accounting research, using a variety of research metrics to measure IFRS quality, have provided considerable evidence on this issue. Below we discuss some of the findings of several research pieces, which we believe are relevant to the SEC as it deliberates on this controversy.

One stream of research focuses on the behavioral changes of users and preparers subsequent to a firm's adoption of IFRS. Ashbaugh and Pincus (2001) report that after the adoption of IFRS, analysts' forecast accuracy improved. Cuijpers and Buijink (2005) using a sample of firms in the European Union, provides evidence that analyst following increased. Choosing a sample period from 1989 to 1999, Bradshaw *et al.* (2004) studied whether US institutional investors prefer to invest in non-US firms whose accounting methods conform more closely to US GAAP (hereafter, "US GAAP conformers"). These authors find that US GAAP conformers enjoy greater US institutional ownership. Moreover, this relation is magnified when the firm lists as an American Depository Receipt (ADR) in the US. These authors also report that increases in US GAAP conformity precede increases in US institutional investment, thus suggesting the possibility of a causal relationship between foreign investment decisions and accounting choice. Bradshaw *et al.* (2004) surmise that US institutional

investors might prefer greater US GAAP conformity because it reduces their information processing costs. On the other hand, they may prefer US GAAP conformers because they believe that foreign GAAP is of lower quality.

This study focuses on US institutional investment outside of US capital markets and does not address the quality of IFRS relative to US GAAP. Although the study reveals a home-GAAP preference that affects investment decisions, the implications drawn concerning US institutional ownership of foreign firms are at best speculative.

Covrig *et al.* (2007) find that foreign mutual fund ownership is higher among firms using International Accounting Standards (IAS) compared with firms using local GAAP. This study examines firms trading outside the US capital markets and uses a sample period from 1999 to 2002 and includes firms from 29 countries. These authors also report that foreign mutual fund ownership increases subsequent to IAS adoption.

Barth *et al.* (2007) examine whether the accounting amounts from the application of IAS is associated with higher accounting quality. Noting that the application of IAS reflects the combined effects of features of the financial reporting system, including standards, their interpretation, enforcement, and litigation, these authors document that firms applying IAS from 21 countries generally evidence less earnings management, more timely loss recognition, and more value relevance of accounting amounts than matched sample firms applying non-US domestic standards. Barth *et al.* (2007) interpret earnings that exhibit less earnings management as being of higher quality. Their measurements for earnings management are based on the variance of the change in net income, the ratio of the variance of the change in net income to the variance of the change in cash flows, the correlation between accruals and cash flows, and the frequency of a small positive net income. These authors interpret the frequency of large negative net income as less earnings management and thus better accounting quality. As discussed later on in the paper, Barth *et al.* (2007) metrics for value relevance are the explanatory powers of net income and equity book value for prices, and stock returns for earnings.

Since firms were not randomly assigned to the IAS group, this study does suffer from a self-selection bias. However, Barth *et al.* did use several research design features to partially ensure that their results are attributable to the change in the financial reporting system rather than to changes in firm's incentives and the economic environment.

The value relevance literature is another stream of research that throws some light on the quality of IFRS. This line of research assumes that the higher the correlation between accounting amounts (for example, earnings) and stock returns, the higher the reporting quality. Researchers in this area argue that higher quality accounting results from applying accounting standards that require recognition of amounts that are intended to faithfully represent a firm's underlying economics. Further, higher quality accounting is less subject to opportunistic managerial discretion and has less non-opportunistic error in estimating accounting accruals (Barth *et al.*, 2007). We now examine some of these studies.

Several value relevance studies have documented that countries with similar accounting standards (such as, Anglo-Saxon countries: the United States, Canada, the United Kingdom, and Australia) exhibit similar correlations between accounting amounts and stock returns (for example, Alford *et al.*, 1993; Pope and Walker, 1999). Also, as reported by Harris *et al.* (1994) and Alford *et al.* (1993), some European firms that use their home-GAAP report similar market correlations with accounting

amounts. Since IFRS reflect accounting standards from several big Anglo-Saxon and European countries, this research does suggest that IFRS are parallel to US GAAP.

Bartov *et al.* (2005) examine the value relevance of US GAAP, IAS, and German GAAP by measuring the association between earnings and stock returns. These authors find a stronger earnings/returns relationship for IAS and US GAAP over German GAAP, but is unable to determine any significant difference in the earnings/returns relation between IAS and US GAAP. Bartov *et al.* (2005) assert that US GAAP does not trump IAS in terms of value relevance.

As alluded to earlier, Barth *et al.* (2007) in studying the quality of IAS amounts use several value relevance metrics to determine the quality of accounting amounts that are based on IAS standards. These authors' first metric is based on the explanatory power from a regression of stock price on net income and equity book value. Their second and third relevance metrics are based on the explanatory power from regressions of net income per share on annual stock return. Noting that accounting quality differences are most pronounced for "bad news" because when firms have "good news" they have less incentive to manage earnings (Ball *et al.*, 2003), Barth *et al.* (2007) estimate the earnings/returns relationship separately for positive and negative return subsamples. Basing their inferences from a broad sample of firms in 21 countries that adopted IAS between 1994 and 2003, these authors document for their regressions of price on net income and equity book value in the post-adoption period, that IAS firms exhibit greater accounting quality than the non-IAS (NIAS) firms. Since the explained variations of the price regressions in the pre-adoption period for the IAS and NIAS firms were insignificantly different, Barth *et al.* argued that the higher value relevance for IAS firms is not attributable to higher value relevance in the pre-adoption period. Their results also reveal for the price regressions an increase in value relevance with application of IAS. However, the value relevance results were insignificant for the returns regression in both the pre- and post-adoption period.

Rather than looking at the earnings/return relationship to measure accounting quality, Leuz (2003) investigates whether firms using US GAAP versus IAS manifest differences in information asymmetry and market liquidity. The underlying theory is that better accounting quality eventuates in a better total flow of information to the market, thereby lowering the information asymmetry among investors. This further contributes to enhanced liquidity in the capital markets. Since institutional factors, as alluded to earlier, can affect accounting quality irrespective of whether accounting standards are good or bad, Leuz limits his sample to firms trading in Germany's New Market. Using a sample comprised of 69 firms in 1999 and 195 firms in 2000, this author finds that differences in the bid-ask spread, share turnover, analyst forecast dispersion, and initial public offering underpricing between US GAAP and IAS firms are statistically and economically insignificant. Leuz (2003) concludes that the difference between IAS and US GAAP in terms of information asymmetry and market liquidity is inconsequential. Since both the Leuz and Bartov studies were not conducted in the USA, the results may not be applicable to the US capital markets.

Daske (2006) examines the common belief that higher quality accounting information tends to lower a firm's cost of equity capital. This view has traditionally been advanced on the theory that higher information quality either lowers the estimation risk of future returns, or that it lowers the information asymmetry between the firm and the market, which increases market liquidity thereby

lowering the required rates of return. Using a sample of firms on the German Stock Exchange, Daske studies the relationship between accounting standards (i.e. IAS/IFRS, US GAAP, and German GAAP) on a firm's cost of equity capital. For a sample period covering 1993 through 2002, Daske (2006) finds no evidence of a lower cost of equity capital for firms using IAS/IFRS or US GAAP relative to firms employing German GAAP. However, he did find some evidence that IAS/IFRS firms did witness a higher cost of equity capital than US or German GAAP firms. Investigating the firms that did switch from German GAAP to IAS/IFRS, Daske is unable to document a change in cost of equity capital for these firms. This latter finding, which fails to corroborate Daske's earlier findings of a higher cost of equity capital for IAS/IFRS firms, may be the result of a lack of statistical power induced by a small sample.

Daske (2006) surmises that his weak results may be attributed to the accounting diversity created by the coexistence of three alternative reporting regimes that characterized the German Stock Market during the time span studied. This author further suggests that the speed of the "accounting revolution" coupled with the lack of available accounting information for comparable periods caused significant uncertainty among investors during this transition period in the German Stock Market. Daske believes that it is this uncertainty among investors that prevented the cost of equity capital from being lower for IAS/IFRS firms.

The above research suggests that IFRS reflects comparable quality to US GAAP. Moreover, the SEC, which had fallen behind the tide, is now about to board the ship of a single, high quality set of global accounting standards, as it makes its way around the world. With capital markets becoming more and more inextricably linked, the empirical research suggests that IFRS represents a single set of high-quality, globally accepted accounting standards that can enhance comparability of financial reporting across the globe. This increased comparability of financial information would lead to better investment decisions and a more optimal allocation of resources across the globe's economy.

### Concluding remarks

Value relevance studies, in general, are based on the market response to some accounting variable, for example, income as reported under IFRS. Can we rely on these studies to guide standard setters in their policy decisions? Indeed, it is tempting to conclude that the best accounting policy should be based on the variable that has the greatest market response. For example, if net income as reported under IFRS shows a greater market response than net income as reported under US GAAP, IFRS-net income should be used. This is because investors find it a "higher-quality" number and thus more useful in their decision making. However, this conclusion may not be warranted when one recognizes that information has the characteristics of a public good. By definition a public good is a good such that consumption by one person does not destroy it for use by another. Although accountants may be better off by producing higher quality information that is more useful to investors, it does not follow that society will necessarily be better off. The reason is investors view this information as free and will do what any other rational consumer will do when prices are insignificant, that is, consume more of it. Consequently, investors may demand more useful information even though from society's perspective the costs of producing this information exceed the benefits. Notwithstanding this caveat, it is still true that



“accountants can be guided by market response to maintain and improve their competitive position as suppliers to the marketplace for information” (Scott, 2006).

As noted earlier in this paper, good quality financial reporting does not only depend on having high quality accounting standards. It is also a function of the incentives of preparers, auditors, and users of financial reports. These incentives in turn are influenced by enforcement mechanisms, legal infrastructure, governance structures, educational system, training, etc. In a study controlling for the quality of accounting standards, Ball *et al.* (2003), examining a sample of firms from four East Asian countries, conclude that “incentives appear to dominate accounting standards as a determinant of financial reporting” and one must weigh heavily the role of institutional factors in shaping preparers’ financial reporting incentives. Given the huge disparity in institutional structures across the globe, the SEC must acknowledge that implementation of even the highest quality accounting standards could result in suboptimal accounting numbers.

Is competition among accounting standards essential in the development of high-quality accounting standards? Sunder (2002) argues that no standard setting body has information to confidently assess the consequences and relative merits of alternative accounting standards. He visualizes a capital market where investors will place a premium on firms that choose accounting standards that best reflect the firm’s financial results. Since managers are interested in minimizing the firm’s cost of capital, they will choose those accounting standards that investors find more useful. These market forces will result in managers rewarding the standard setting organization, such as the IASB, by choosing its standards. Thus, managers’ favor for a particular standard setter will further incentivize it to produce even better accounting standards.

Although we believe this is a good argument for market forces, we do believe that the SEC ought to bite the bullet and allow all public companies to file their financial reports only under IFRS. Having dual reporting standards in the USA will cause confusion among investors and will certainly not satisfy the SEC’s objectives of reliable, consistent, high-quality accounting amounts, and enhanced comparability across the globe. Admittedly, incentives of preparers, auditors, and users differ significantly across the globe and this can certainly lead to shoddy financial reporting, even with the very best standards. Indeed, this is currently the state of financial reporting that has characterized the world’s economy from time immemorial. Clearly, a single set of high-quality, globally accepted accounting standards has the potential to significantly improve financial reporting comparability among companies, irrespective of their place of domicile. The IFRS ship is already making its way around the world as a single set of high quality global accounting standards. Clearly, the time has come for the US SEC to jump on board.

#### Notes

1. International Accounting Standards (IAS) were issued by the International Accounting Standards Committee (IASC). The International Accounting Standards Board (IASB), the successor body to the IASC in 2001, issues International Financial Reporting Standards (IFRS), which include standards issued not only by the IASB but also by the IASC. Some of the IAS have been amended by the IASB. In this paper, the acronyms IFRS, IAS, and IAS/IFRS can be construed as a body of international accounting standards without any loss of meaning.
2. The empirical evidence on whether earnings reconciliation from foreign accounting standards to US GAAP is indirect and mixed. For a review in this area see Chen and Sami (2008).

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