Does IFRS Reduce 'Home Bias' in Asset Management ?

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ABSTRACT

This paper examines the question-does adoption of IFRS reduce the home bias? Even after the proponents and skeptics are at loggerheads over the benefits of adoption of IFRS, this study advocates that the widespread adoption of IFRS (International Financial Reporting Standards) is unlikely to reduce the uncertainty about foreign financial reporting quality, familiarity bias, and geographical proximity bias that act as catalysts towards home bias.

Key Words: *IFRS, Economic network theory, Familiarity bias, Proximity Bias, Home Bias*

I. INTRODUCTION

The international capital asset pricing model, based on traditional portfolio theory developed by Sharpe (1964) and Linter (1965), posits that to maximize risk-adjusted returns investors should hold the 'world market portfolio' of risky assets, irrespective of their country of residence. In practice, however, the proportion of foreign assets in investors' portfolios tends to be very small. In the case of equities, foreign stocks make up a disproportionately small share of investors' equity holdings when one considers relative stock market capitalizations. Despite the well-documented gains from international diversification (Solnik, 1974; DeSantis and Gerard, 1997), the strong preference for domestic equities exhibited by investors in international markets remains an elusive empirical puzzle in financial economics. The pattern of integration of international financial markets offers opportunity for risk diversification by holding up the maxim "Don't put all your eggs in one basket". Investors could significantly reduce their risk exposure if they hold a fraction of their asset portfolio in foreign stocks that bear favorable risk to them. Surprisingly, investors do not exploit this risk sharing opportunity, instead they hold large share of their portfolio in domestic stocks. In the economic literature this phenomenon is dubbed as the "home bias puzzle". Even researchers show that gains from international portfolio diversification are significantly positive for all markets especially for the emerging ones (Roy, Ray and Roy, 2012).

Home bias behavior appears to be a grossly disturbing one from a diversification standpoint. Academics have offered a variety of explanations for this phenomenon. Initial explanations focused on barriers to international investment like, governmental restrictions on foreign and domestic capital flows, foreign taxes, and high transactions costs (Stulz, 1981). Although many of these obstacles to foreign investment have gradually diminished over time, the propensity to invest in one's home country still remains strong. Again, when capital crosses national boundaries, it faces the problems like exchange risk, variation in regulation towards control and convertibility of capital, cultural shocks and sovereign risk, which, in general, are considered as the primary factors discouraging investment abroad. Furthermore, researchers argued that informational differences between foreign and domestic investors are the driving force behind the home bias. Investors, in general, have easier access to information about companies located nearer to them. They prefer local firms rather than distant ones for which they have a relative disadvantage in the context of

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information. More generally, investors have a preference for geographically proximate investments arising from a number of potential sources.

Advocates of International Financial Reporting Standards (IFRS) claim that if a country adopts the IFRS, it will help in bringing harmony between the numerous accounting standards in different countries, improving usefulness of financial statements, transparency in a global marketplace and also facilitate in removing the information asymmetry, thereby, encourage investors to hold international instruments in their portfolios. Given the effect that a global set of accounting standards could have on the information available to investors, it is possible that the global adoption of IFRS could mitigate investors' home bias (Bradshaw et. al., 2004).

The idea of adopting IFRS to develop international comparability of financial statements has become widespread with the advent of financial globalization. The adoption of IFRS by public firms around the world is one of the most significant financial accounting and reporting changes in the history of accounting. With the globalization of financial markets, more than 100 countries have agreed to require or allow adoption of IFRS, or have established timelines for the adoption of IFRS. In Europe, every publicly traded company in the European Union (EU) member state is required to apply IFRS when preparing the consolidated financial statements (IAS Plus (a). n. d.). In the U.S., the Securities and Exchange Commission (SEC) has allowed non-US firms to file financial statements in accordance with IFRS of the International Accounting Standard Board (IASB) without reconciliation (SEC, 2007). In Asia, countries with substantial economies, like, Japan, China, and India are either in the process of transitioning to IFRS or have already converged to IFRS (PwC, 2008). The US Securities and Exchange Commission (SEC) advocated that reporting under IFRS would promote international compatibility when foreign companies are allowed to access US capital markets (SEC, 2007). In the European Union, companies were asked to prepare their consolidated accounts in conformity with IFRS. The IFRS consists of approximately 40 standards and 25 interpretations. This standard is considered to be more principles-based than US Generally Accepted Accounting Principles (GAAP). It relies less on detailed rules, and allow greater flexibility than US GAAP. At the same time, IFRS tends to be more restrictive in terms of measurement choices and requires more disclosures relative to most local accounting standards.

Proponents argue that adoption of IFRS may reduce information processing costs by making it less costly to analyze foreign financial statements and by increasing investors' perceived competence in foreign investment. However, skeptics argue that the adoption of IFRS is likely a process of pouring old wine in a new bottle. It generates no new information but simply repackages existing financial statement information and there is no rational basis for expecting a reduction in the home bias by simply adopting IFRS.

II. OBJECTIVE OF THE STUDY

Given the above backdrop, the present study examines the question-does the adoption of the International Financial Reporting Standards (IFRS) reduces 'home bias' in portfolio management? As the adoption of IFRS leads to an informational change, this paper attempts to a theoretic discussion on the impact of adoption of IFRS on information processing cost in relation to the home bias. The paper specifically attempts to find the answer to the question: 'what prompted the countries to adopt IFRS and what are the reasons for the home bias. The paper also theoretically examines the impact of the IFRS on the Home Bias and highlights the areas for further research.

III. ADOPTION OF IFRS

Why do countries adopt International Financial Reporting Standards? It is argued that switching to IFRS from GAAP will help companies, investors, and the general public to compare financial statements easier. The 'comparability argument' is founded on the assumption that IFRS reporting makes it less costly for investors to compare firms across markets and countries (Armstrong et al., 2007; Covrig et al., 2007). If every country has a different set of accounting standards, it is difficult to compare the financial position of each company because there is no consistency. Consistency is a key factor in comparing financial statements. Without one common set of global standards, it will be more difficult, if not impossible, to compare financial statements of the competitors. Such a comparison also involves the consumption of extra time and money. With an international accounting standard in place it allows companies and competitors to be able to compare each other with a lesser amount of cost and energy. Consistency is not only important for comparability, but also for everyone to understand financial statements across the countries. Advocates of international financial reporting standards claim that the standards make financial statements easy to understand and interpret. Adopting and reporting under IFRS, a company's position strengthens in negotiations with credit institutions which ultimately reduce the cost of borrowing, because IFRS has a positive effect on credit ratings (Albrecht, 2008). IFRS will also make it easier for companies to initiate joint-ventureship, implement cross-border acquisitions and mergers, and develop cooperation agreements with foreign entities (Pricewaterhouse, 2008). All these advantages will certainly assist to improve a company's overall position in the global economy.

It is often argued that accounting standards setting is shaped by both economical and political considerations (Ball, 2006). It is also observed that, to improve the transparency in reporting and in framing and recommending standards, the International Accounting Standards Board (IASB) has to consider a variety of issues and interests of different parties including multinational corporations, audit firms, investment banks, international financial institutions, and various public authorities in Europe, China, U.S. and elsewhere (Veron, 2007). If transparency improves due to adoption of IFRS then, investors should have a better understanding about the actual economic and financial performance across a wide range of firms and be better able to compare the performance of firms domiciled in different countries. For instance, a common set of accounting standards could help investors to differentiate between the firms with sound or weak financial health, which in turn could reduce information asymmetries among investors, lower estimation risk and cost of capital. When adopted in several countries, common standards may also lower the cost in analyzing, monitoring and evaluating the performance of firms across countries (Ball, 2006). Thus, global movement towards adoption of IFRS in reporting may then augment cross-border investment and integration of capital markets (Covrig et al., 2007). Making foreign investment easier could also improve the liquidity of the capital markets and enlarge firms' investor base, which in turn could improve risk-sharing and lower the cost of capital (Merton, 1987). It is likely that this has a positive effect on both the investors' ability to interpret financial statements and their willingness to buy stocks across the countries and reduce the 'home bias' phenomenon that most investors are prone to (Cooper and Kaplanis, 1994). Such positive effects are likely to be more significant in emerging and relatively small economies. The adoption of IFRS will enhance the effectiveness of competition for international funds amongst the countries and make international capital markets more efficient, leading to a lower cost of capital for firms. In terms of transparency IFRS reduce the amount of reporting discretion relative to many local GAAP and, in particular, push listed firms in financial markets to improve their financial reporting. The study of Ewert and Wagenhofer (2005) show that tightening the accounting standards can reduce the level of earnings management and improve reporting quality. These expected benefits are based on the premise that mandating the use of IFRS increases transparency and improves the quality of financial reporting.

The decision to adopt IFRS by a country may be analysed as a decision to adopt a product with network effects. Economic network theory posits that in addition to network benefits (synchronisation value), a product with network effects can be adopted due to its direct benefits (autarky value) (Ramanna and Sletten, 2009). Network theory explains the inter-temporal increase in the adoption of IFRS across countries. A standard like IFRS is likely to be more appealing to a country if other countries choose to adopt the standard as well. The economic theory of networks can help us here more to seek the answer to the issue: 'why countries choose to adopt IFRS?' Network theory suggests that there are generally two factors to consider in adopting network-dependent products: (i) the intrinsic value of the product and (ii) the value of the product's network (Katz and Shapiro, 1985). If IFRS is considered a network-dependent product, then a country's decision to adopt IFRS can be viewed through the autarky and synchronization values. The autarky value of IFRS is the direct value to the adopting country from using the IASB-developed accounting standards. The synchronization value is the value derived from adopting a body of accounting standards that is widely used by other countries. Evidences show that the likelihood of IFRS adoption for a given country is increasing with the number of IFRS adopters in its geographical region and with IFRS adoption among its trade partners (Ramanna and Sletten, 2009). The result is significant for at least two reasons: (i) it suggests countries internalise the network effects of IFRS in their adoption decisions; and (ii) it suggests that as possibility of getting the network benefits from IFRS are large, countries may adopt the international standards even if the direct economic benefits from such standards are inferior to those from locally developed standards. In the case of the IFRS adoption decision by a country, it can be argued that the direct benefits are represented by both the net economic and net political value of IFRS over local standards (Ramanna and Sletten, 2009).

The actual benefits of mandatory adoption of new standards across countries are closely debated by the academics and practitioners. Some argue that the IFR standards introduce uncertainty in the evaluation of financial standards as the standards permit managers to exercise their own judgment when deciding what to report in their financial statements. This may lead to possible errors in statements which can cause shareholders, investors, and the general public not to have as much belief in the financial statements. With the uncertainty in financial statements, this may also prevent companies from possibly receiving loans from various financial institutions (Albrecht, 2008). Secondly, unlike GAAP, there isn't much enforcement with IFRS. This could cause a problem for fraudulent financial statements which leads back to uncertainty with those statements. Moreover, "…many countries that claim to be converting to international standards may never get to 100 percent compliance. Most reserve the right to carve out selectively or modify standards they do not consider in their national interest, an action that could lead to incomparability – one of the very issues that IFRS seeks to address" (American Institute of Certified Public Accountants, 2008).

Leuz (2003) has compared international and US standards and concluded that IFRS is a high quality set of accounting standards and is equivalent to US GAAP in terms of reducing information asymmetries and in terms of value relevance. Lang et al. (2006) note that despite the use of the same accounting standards, financial statements of cross-listed and US firms are not comparable and earnings management is more pervasive in non-US firms than in US-based companies. This raises the question, whether the widespread adoption of IFRS would actually reduce the tendency of the investors to invest more in domestic instruments.

Before delving into the crux of the problem as to how IFRS adoption can mitigate the home bias, it would be worthy to look into the question-why does home bias occur?

IV. REASONS FOR HOME BIAS

The domestic bias in international investment presents a major puzzle to financial economists. It is argued that the home bias and anomalies in capital markets arise due to informational differences. The bias towards local market investment has been explained by familiarity bias. In the context of investment in capital markets, investors may on an average be better informed about the risk-return characteristics of domestic investible instruments than that of the foreign one. Foreign investments appear more risky and investors rationally bias their portfolios towards the less risky, as perceived by them, domestic assets. This does not imply that investor is better informed about domestic stock than any foreign investor. Superior information on firms earnings prospects is captured not only by the mere fact that domestic investors in general do have a better understanding of the nature of business of domestic firms, but also by the aspect that it is more difficult for foreigners to translate and interpret balance sheet information accurately. Malloy (2005), shows that the forecasts of the local analysts are more accurate and value relevant than the forecasts of foreign analysts. Bae et al. also (2008) show that analysts resident in a country make more precise earnings forecasts for firms in that country than non-resident analysts. Behavioral finance research suggests that investors tend to be more optimistic towards home markets than towards international markets (Huberman, 2001). The home bias can also be explained by investors' perception about their competence in interpreting financial statements of foreign companies. Graham et. al. (2009) finds a positive relation between an investor's perceived competence and the international diversification of his portfolio of investments. Due to perceived lack of competence in analyzing financial statement of foreign companies, the investors is likely to refrain from investing abroad that might lead to underinvestment in foreign stocks. Although information processing costs and competence effects are likely material for individual and retail investors contemplating foreign investments, but they are significant for institutional investors. Empirical researchers suggest that while individual (nonprofessional) investors lack investment expertise and have ill-defined valuation models (Maines and McDaniel, 2000), professional investors "have well-defined valuation models which, in turn, allow them to use directed information search strategies to acquire the inputs needed for their valuation models" (Frederickson and Miller, 2004, p. 673). This suggests that differences in financial statement presentation across companies from different countries are not likely to lead to significant information processing costs for institutional investors.

Explanations in the financial literature for the home bias can be categorised as (i) regulatory or political constraints. Constraints on flow of funds across countries, explicit limits to cross-border equity investments, exchange rate risk, purchasing power risk, taxes, and higher transaction costs are examples of regulatory and political constraints to international equity diversification. (ii) Information costs. Investor perception of higher risk due to greater information asymmetry in foreign stocks is an example of information-based constraints to foreign investment.

There are three types of information frictions that generally pave the way for home bias: costs of information processing, uncertainty about financial reporting quality, and uncertainty about the distribution of future cash flows. Information processing costs refer to the costs of becoming familiar with the financial statements of foreign companies, interpreting the information, and being able to compare the financial statements across companies for investment decisions. When investors contemplate purchasing equity in a foreign company, they must glean from published accounts information that is based on accounting principles and disclosure requirements that may differ greatly from those in their home country. Moreover, the credibility of this information is determined to a large extent by the regulatory environment, which also varies considerably from country to country. Cross-country differences in accounting principles, disclosure requirements, and regulatory environments--which together can be grouped as investor protection regulations--give rise to information costs that must be borne by foreign investors. Information processing costs associated with investing in some countries may be significantly higher than the others. Research suggests that difficulty in interpreting financial statements using different accounting standards can act as an impediment to foreign investment that foreign ownership increases in companies that adopt international accounting standards (Covrig et al., 2007), and that US ownership increases in companies that adopt standards that conform more closely to US standards (Bradshaw et al., 2004). One interpretation of this evidence is that global adoption of uniform standards reduces information processing costs and underinvestment in foreign equity markets.

Information friction can also arise from investors' uncertainty about the quality of financial reporting in foreign countries. There is evidence suggesting that IFRS is a set of accounting standards of high quality (Leuz, 2003), and IFRS is likely to improve financial reporting quality for most countries (Ashbaugh and Pincus, 2001). This evidence suggests that investors are more likely to rely on the financial statements of foreign companies and increase foreign investment after global IFRS adoption. But on the contrary, research suggests that for any given set of accounting standards, there can be significant differences in financial reporting outcomes depending on the quality of the investor protection and enforcement environment across countries (Lang et al., 2006) which in turn can act as a catalyst for the home bias.

The third type of information cost relates to investors' uncertainty about the distribution of future cash flows. Investors tend to favour foreign companies about which they are better informed and that produce a familiar output, have richer information sets, and whose country of origin is one with which investors have cultural ties (Dahlquist and Robertsson, 2001). Home bias could result from domestic investors having an information advantage over foreign investors about the distribution of companies' expected future cash flows. Furthermore, investors prefer to invest in companies that are geographically closer- a geographic proximity bias - because they are expected to have precise information as a result of greater access and more frequent interaction (Coval and Moskowitz, 1999).

In sum, it is evident that information processing costs is one of the major sources of the home bias. Hence, it is necessary to examine what role does the IFRS play in reducing home bias?

V. IFRS AND HOME BIAS

The expected benefits for mandating the use of IFRS are based on the premise that it increases transparency and improves the quality of financial reporting. However, accounting standards play only a limited role in determining observed reporting quality. The application of accounting standards involves considerable judgment and the use of private information. As a result, IFRS, like any other set of accounting standards, provide managers with substantial discretion. How far this discretion is used depends on firm-specific characteristics and national legal institutions (Ball et al., 2003).

The legal and shareholder protection environment of a country is as important as the accounting standards in determining the quality of financial reporting. A country's shareholder protection and regulatory environment affects information uncertainty and appears to be a factor in investors' decisions. Ahearne et al. (2004) show that when foreign companies list on US exchanges, US investors face lower information uncertainty and invest more. Their results suggest that the investor protection environment is an important determinant of investment choices. Differences in financial reporting outcomes depend on differences in investor protection and enforcement environments across countries. Bradshaw and Miller (2008) compare compliance with US GAAP by foreign companies that voluntarily adopt US GAAP to compliance with US GAAP by a matched sample of US companies. The authors conclude that enforcement is a significant issue with respect to accounting standards.

Indeed, countries' institutional structures play an important role in explaining accounting quality after the adoption of IFRS. Strict enforcement regimes and sound institutional structures provide strong incentives for high-quality financial reports after the introduction of IFRS. In terms of implementation of accounting standards, research has examined cross-country variation in conservatism and earnings management. Ball et al. (2000) find differences in the timeliness of the reporting of losses and conservatism based on whether the company is from a common law or a code law country. They find that companies in common law countries recognize economic losses in income more quickly than companies in other countries. Their finding suggests that institutional structure greatly influences the financial reporting outcomes and institutional factors appear to be more important than the quality of the accounting standards in explaining the timeliness of companies reporting losses. Undeniably, the quality of accounting data and reports depends more on the conservative approach adopted by the recommending body to set the accounting standards. But, the studies in this context are not clearly converging to a single conclusion on the individual role of accounting standards and the institutional environments in determining the interpretive value and the quality of reports.

Leuz et al. (2003) find evidences that strong shareholder protection limits ability for insider trading which ultimately helps to reduce the incentives of management to mask firm performance. As noted by the American Accounting Association, "cross-country institutional differences will likely result in differences in the implementation of any single set of standards. Thus, IFRS may be a high-quality set of reporting standards (pre-implementation) but the resulting, published financial-statement information could be of low quality given inconsistent cross-border implementation practices" (Financial Reporting Policy Committee, 2007). These findings and arguments grossly suggest that even with global adoption of a uniform set of standards, information uncertainties across countries would still exist due to institutional differences.

Research has suggested that home bias could result from domestic investors having an information advantage over foreign investors about the distribution of companies' future cash flows. This argument suggests that domestic investors have an advantage of credible information available about domestic stocks than about foreign stocks. Bae et al. (2008) find that local analysts have significantly more accurate in forecasting earnings than foreign analysts. The authors attribute the local forecasting superiority to an information advantage related to proximity. Van Nieuwerburgh and Veldkamp (2008) argue that domestic investors can learn what foreigners know about foreign stocks. The authors conclude that a small information advantage in which there is a slight home bias in investment is amplified as the investor chooses to learn more about the assets that he holds until his capacity to learn is exhausted in home assets. Bhattacharya and Groznik (2008) also argue that the home bias may be associated with an information advantage in the form of familiarity with the country. The familiarity might lead to greater investment because of greater information or because of an emotional loyalty to the country. The study of Malloy (2005) has convincingly argued about a correlation between available information quality and geographical proximity in the context of involving 'investors and analysts'. Geographic proximity reduces information acquisition costs and provides access to even private information. Hence, geographically proximate analysts possess an information advantage over other analysts and that this advantage is associated with greater accuracy. Geographic proximity therefore allows investors not only to obtain private non-financial information but also to obtain information to evaluate the reliability of the financial statements and voluntary disclosures. To the extent that home bias is due to geographic proximity, the global adoption of IFRS is unlikely to reduce the magnitude of home bias.

Investors, in general, are more skeptic and face greater uncertainty about the quality of foreign financial statements. Common or retail investors popularly believe that foreign financial reporting is not as reliable and informative as domestic financial statements and even home bias might be related to a behavioral bias toward familiar stocks. Research (Kilka and Weber, 2000) suggests that investors tend to be more optimistic about familiar stocks than unfamiliar stocks and about home markets than international markets. French and Poterba (1991) imputed expected returns for US, Japanese and UK stocks and found that 'each investor is most optimistic about returns in his own country'. While one could argue that the optimism is based on superior information, research suggests that the optimism is not easily explained by an information advantage. Huberman (2001) found that investors who demonstrate local bias have neither experienced superior returns, nor they traded more frequently. To the extent that underinvestment in foreign equities is due to a behavioral bias, global adoption of an uniform accounting standards is unlikely to reduce the home bias.

It is equally argued that global adoption of IFRS could change the volume of underinvestment in foreign equities by tuning investors' perceptions of foreign companies' future cash flows. If IFRS adoption generates no new information but simply repackages existing financial statement information, then there is no rational basis for expecting improved forecasts or a reduction in home bias. The study of Hutton et al., (2006) has shown that the format in which information is presented can affect the investment-related judgments of users of financial information and the financial reporting decisions of preparers of financial information. It is thus possible that the format of presentation under IFRS could lead investors to perceive a change in their ability to forecast cash flows.

Moreover, the 'reporting incentives' argument casts doubt on whether simply changing standards will make the reported numbers more comparable across firms or improve firms' reporting behavior. Firms that move towards greater transparency are unlikely to make material changes to their reporting policies (Ball, 2006). Even when the standards mandate superior accounting practices, it is not clear whether or not firms disclose figures that are genuinely more informative. Even with common standards, observed reporting behavior is expected to differ across firms as long as firms have different reporting incentives. Ball et al. (2003) observed that the incentives faced by managers and auditors in issuing financial statements have greater influence than accounting standards, in spite of their standards being derived from high-quality accounting standards like, the GAAP of US and UK. Hence, there is no reason to believe that simply adoption of IFRS would usher in the expected and advocated benefits. If IFRS adoption generates new information relative to the home-country accounting standards, IFRS adoption could reduce home bias if the standards improve investors' ability to forecast foreign companies' future cash flows. The effect of IFRS on the reduction in information costs is likely to be negligible relative to the effects of other determinants of home bias driven by investors' actual or perceived information advantage from geographical bias than from information about future cash flows available in the financial statements.

VI. CONCLUSION

The present paper examines the impact of adoption of IFRS on the home bias. From the discussion in this paper, it may be concluded that the net effect of adopting IFRS on home bias is rather uncertain. The widespread adoption of IFRS is unlikely to reduce the uncertainty about foreign financial reporting quality, the behavioral bias towards familiar financial instruments, and investors' rational tendencies to invest in geographically proximate financial assets. The factors such as informational frictions faced by investors from differences in language, culture, operating environment, and financial reporting environments are likely to dominate information processing costs related to the accounting standards. Hence, reduction in information processing costs by global adoption of a single set of accounting standards is unlikely to significantly alleviate the home bias. In addition, it may also be argued that the extent to which firms benefit from increased disclosure remains a controversial issue. Even regional differences in economies need to be adequately reflected in a common set of standards. Thus, a single set of standards may not be able to accommodate the differences in national institutional features which may further cause divergent accounting systems.

However, there is no denying that the effect of the adoption of IFRS on investors' home bias is, at present, a virgin area for close research, especially the empirical one. Scholars may examine the impact of the relative importance of accounting standards and the strength of the investors' protection environment on home bias. In the areas of information processing costs, research needs to distinguish between investor preferences for familiar accounting standards and preferences for higher quality accounting standards especially, to what extent familiarity bias plays a role in investor preferences for particular standards. With respect to uncertainty about the quality of financial reporting, research is needed to assess what is meant by higher quality accounting standards and what attributes of accounting standards are desirable.

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