

## New and Revised Accounting Standards for Higher Comparability

Lee, Sang Ho\*

Recently, several standards have been added or revised in the International Financial Reporting Standards as adopted by Korea (K-IFRS). The common thread of the changes is an improvement in financial statement comparability across different firms. By inducing firms to recognize one economic event as the same financial information, the new standards primarily aim to enhance investors' understanding on the nature of corporate revenues and cash flows. An analysis on Korea's listed companies over the past 15 years reveals that an improvement in comparability across firms does substantially enhance investors' valuation effort with regard to the persistence of profits. This implies that comparable information does significantly enhance the understanding of financial information users. Given the limited role served by sell-side analysts as an information intermediary in Korea's capital markets, the revised and new accounting standards aiming for higher comparability are expected to make meaningful contributions to lowering information risk and efficient asset allocation, especially in the KOSDAQ market. Policy authorities need to act in an expeditious and discreet manner, effectively addressing any practical difficulty the industry may face during the transition to the changes.

Recently, many of the international accounting standards have been adopted and revised. On top of the new standards for revenue recognition (IFRS 15) and financial instruments (IFRS 9) since 2018, the leases standard (IFRS 16) also brought significant changes in 2019. By

\* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

\* Ph.D., Research Fellow, Capital Markets Department, Tel: 82-2-3771-0643, E-mail: sangholy@kcmi.re.kr

2022, another new standard regarding insurance contracts (IFRS 17) will be introduced. Those changes could affect the solvency and profitability indicators with varying degrees across industries and firms, imposing a substantial burden on listed companies subject to those standards.

Another concern from the perspective of investors is that the revision will change the way indicators are computed, and thus lower the time-series comparability.<sup>1)</sup> At this juncture, this article explores the policy objectives behind the accounting standard revision, and presents why we need new standards despite the concerns.

### **New standards aiming for greater comparability**

The focus of the new accounting standards is largely placed on the improved comparability of financial information across firms. What's important in "Revenue from Contracts with Customers (IFRS 15)" is the comparability of the information on the revenue, usually a starting point of an income statement, across firms, industries, and countries. The new standard sets forth a set of consistent and comprehensive principles that help specifically identify the duty attached to the contract, and recognize the proper value. Its flexible scheme enables firms to deal with a wide variety of contracts that could arise in the increasingly complex business environment.

The standard of "Financial Instruments (IFRS 9)" redresses the classification and valuation of financial products taking fully into account financial assets' investment purposes and the nature of cash flows in the contract. This requires to recognize the balance of trade receivables in the financial statement more reliably by stipulating that any expected loss from a receivable whose collectibility is doubtful could be recognized even before a credit event occurs.

Under the previous standard, the lessee doesn't have to recognize the assets and associated liabilities because a lease contract doesn't convey ownership rights of the asset. However, the new lease standard (IFRS 16) mandates lessees to recognize lease assets and liabilities, placing a focus on substance over form. This could improve the comparability of financial health in terms of economic substance in many sectors, including aviation and shipping industries with a

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1) Joseilbo, Jun. 28, 2018, IFRS9 push up bad debt allowances for banks and card companies by 33.8%; thebell, May 8, 2019, Dark side of IFRS15: HDC's higher earnings volatility; Financial News, Jun. 2, 2019, New accounting standards hit aviation companies with doubled debt; Yonhap News, Sep. 26, 2018, Insurers carefully managing debt risk under IFRS17.



higher proportion of leased core assets over equity capital, as well as hotels and retail (including duty-free) industries often leasing commercial real estates.

Last but not least, the insurance contract standard (IFRS 17) requires insurers to report insurance liabilities on a mark-to-market basis. This could affect insurance policies guaranteeing fixed, high interest rates. Although the sales of those products guaranteeing interest rates higher than banks did play a role in boosting insurance industry growth, the resultant negative gross profit under the long-term negative interest rate trend is now weighing down insurers. It's possible to properly gauge the increased burden on insurers under the new standard, compared to the current standard (IFRS 4).

**Table 1. Objectives of New and Revised K-IFRS Standards**

Area	Timing	Objectives
Revenue recognition (IFRS 15)	Jan. 1, 2018	To address the mismatch and problems in revenue recognition To improve the comparability of revenues across different firms, industries, nations, and capital markets
Financial instruments (IFRS 9)	Jan. 1, 2018	To simplify financial reporting of financial products To provide time-wise information on expected credit losses
Leases (IFRS 16)	Jan. 1, 2019	To improve the consistency in recognizing assets and liabilities arising from lease rights and obligations To enhance the transparency of a lessee's financial leverage and capital employed
Insurance contracts (IFRS 17)	Jan. 1, 2022 (TBC)	To improve the consistency in bookkeeping related to insurance contracts across different products and nations To help investors and financial analysts better understand insurance accounting

Source: K-IFRS Standards

**New standards incurring (in)direct management costs**

The rationale behind the new standards is to improve the comparability across firms, industries, and nations, which is quite convincing. However, it's necessary to ponder upon the cost of regulatory compliance on firms. The principle-based IFRS underscores professional judgment and accountability in interpretation and application. This incurs a wide array of direct costs associated with information production, e.g. expert advising and task forces to review the new standards. In addition, a broad-ranged revision in the standards would require firms to build a new accounting system that incurs substantial budgets.<sup>2)</sup>

2) It took KRW 17.3 billion and a total of 130 staff working for two years and three months for the Korea Insurance Development Institute consortium to build the IFRS 17 system (KIDI, Oct. 24, 2019, Korea's First GPU-based IFRS 17 System ARK, Press Release).

Also notable is the indirect cost arising under certain conditions. When a change in a firm's financial ratios triggers an early repayment event and thus adversely affects the credit ratings, it might have to replenish its capital. In another case, higher volatility in profits and losses could derail the decision making process for dividends, and require a reconsideration of another risk hedging tool to prepare for a change in equity capital. Although the new standards aim to improve comparability across firms, any change in computation standards could deter comparability over time and thus confuse investors.

### **Expected outcomes: Improved financial literacy**

A revision in the accounting standards would not only incur costs associated with producing accounting information but also impose direct and indirect impacts on corporate financing decisions. Given that those costs are finally borne by shareholders, it's the right time to ponder over how shareholders would benefit from the new accounting standards.

If the new accounting standards fully achieve the intended objectives—minimizing the gap between economic substance and accounting, providing users purposeful and useful information on corporate profits and cash flows, improving the comparability across firms, industries, and nations, this is expected to enhance market participants' accounting literacy.

The existing literature on the usability of comparable information in Korea shows that sell-side analysts' earnings forecasts become more accurate as a firm's financial information gets more comparable to that of another firm. This is confirmed to improve the predictability of professional investors.<sup>3)</sup> However, Korea's capital markets have only a limited number of firms that are covered by analysts.<sup>4)</sup> And it's hard to assume that general investors have information-processing ability similar to that of sophisticated investors.<sup>5)</sup> In other words, a separate analysis is needed to find out whether ordinary investors could deepen their understanding about a firm of interest by using comparable financial information to the extent that professional investors do.

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3) Kang, M.J., Lee, M.G., and Lee, H.Y., 2013, The impact of financial reporting comparability on analyst forecasts and value relevance, *Korea Accounting Review*, 38(1), 281-320.

4) More precisely, only 30.3% of KOSPI-listed and 3.2% of KOSDAQ-listed firms are covered by more than three analysts and thus have available earnings forecasts between 2001 and 2018 (Source: FnGuide, FY1 earnings forecasts data for the past three months were collected at the end of June).

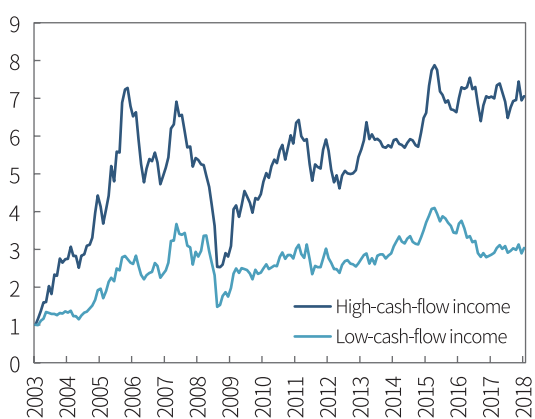
5) Bartov, E., Radhakrishnan, S., Krinsky, I., 2000, Investor sophistication and patterns in stock returns after earnings announcements, *Accounting Review* 75(1), 43-63.



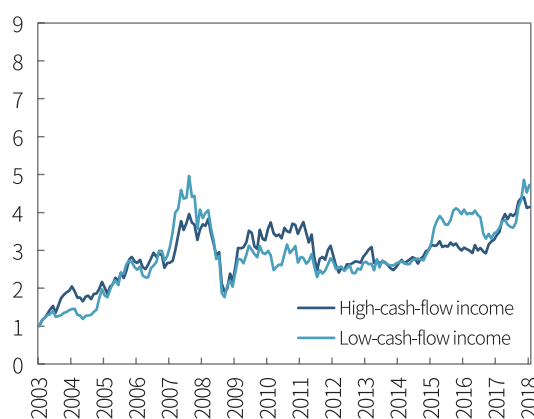
This article first measures the comparability of financial statements across firms based on how their financial statements reflect one economic event,<sup>6)</sup> and then carries out an analysis on how ordinary investors effectively identify income generating cash flows (high-cash-flow income, hereinafter) from that without cash flows (low-cash-flow income, hereinafter) according to different levels of comparability. In general, high-cash-flow income tends to persist in the future than the low-cash-flow one does, but ordinary investors could hardly recognize that.<sup>7)</sup>

The results confirm that an improvement in financial statement comparability across firms does evidently improve investors’ valuation error regarding the persistency of income. With dividing firms into three groups according to the level of comparability, Figure 1 shows the changes in valuation in the lowest-comparability group. The valuation gap between buying on the reporting of high-cash-flow income and low-cash-flow income is found to widen persistently. On the contrary, the highest-comparability group illustrated in Figure 2 rarely shows such a gap.<sup>8)</sup> This means that the lack of comparable information predisposes investors to underestimate high-cash-flow income, which delays the reflection of the positive cash flows into the asset prices. On the other hand, investors value earnings quite efficiently when there’s

**Figure 1. Valuation of the lowest-comparability group**



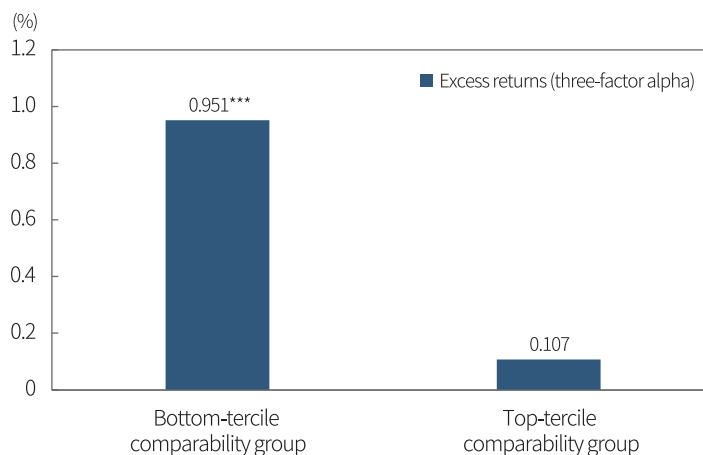
**Figure 2. Valuation of the highest-comparability group**



6) De Franco, G., Kothari, S.P., Verdi, R.S., 2011, The benefits of financial statement comparability, *Journal of Accounting Research* 49(4), 895–931.  
 7) Sloan, R.G., 1996, Do Stock Prices Fully Reflect Information in Accruals and Cash Flows about Future Earnings?, *The Accounting Review* 71(3), 289–315.  
 8) The portfolio is reconstructed at the beginning of April in year t+1 using the year t financial statement whose fiscal year ends in December. It is assumed that the return of a delisted firm is 0% and there’s no transaction cost. The data are value-weighted returns accrued from the base index starting from 1.

a sufficient supply of comparable information. As shown in Figure 3, with market, size, and growth factors controlled, the inefficiency in financial statement interpretation is significant only when the supply of comparable information is limited.

**Figure 3. Monthly average returns on arbitrage**



**Implications**

The new and revised accounting standards enacted recently are purposed to provide more comparable information across firms and thus have a clear conceptual advantage. According to the analysis on the 15-year data, an improvement in financial statement comparability is expected to contribute greatly to enhancing the accounting literacy of market participants in Korea’s capital markets. Particularly in the KOSDAQ market where stock analysts have an extremely limited role in intermediating information, the provision of comparable information could effectively address the information asymmetry issue. More specifically, this is forecast to reduce information risk, bolster external monitoring, and enhance the efficiency of asset allocation, all of which have been sought after by investors.

At the early stage of the new standards, the process of regulatory compliance will definitely incur costs in many areas. Although this eventually brings down the shareholder value, it’s worth noting the temporal aspect of the costs. Because those are not expected to incur persistently, their impact on the going concern value will be highly insignificant. On the other hand, improved investor understanding and the resultant fall in information risk are directly linked to the discount rate, and wield unmeasurably large influence over the firm value.



In response to the potential issues during the process of applying the new standards, policy authorities need to revise the regulation in advance and reduce the burden on shareholders. Any difficulty in interpreting the principle-based accounting standards or any ambiguity in applying the standards to complex transactions should be dealt with by specific, detailed guidelines. Also necessary is a full reevaluation on any potential conflict between the Commercial Act and tax laws in an expeditious and discreet manner, which will help reduce any confusion.

On another front, some are raising doubts about the rationality of the new standards, arguing that the change in the standards might worsen the key performance indicators even if there's no change in a firm's economic reality. They also worry about any case where capital replenishment is needed to improve the financial structure. IASB Chair Hans Hoogervorst once mentioned that a desirable accounting standard could give prior warning of risk that is often unnoticed by external investors and internal management. It's worth contemplating whether a firm's economic reality has actually nothing to do with the changes to be brought about by the new standards, i.e., recognizing off-balance sheet liabilities, reflecting losses from the payables expected to incur a negative gross profit, etc. A clear diagnosis should precede a proposed improvement. The new accounting standards are expected to provide more useful and comparable information on a firm's current financial conditions.