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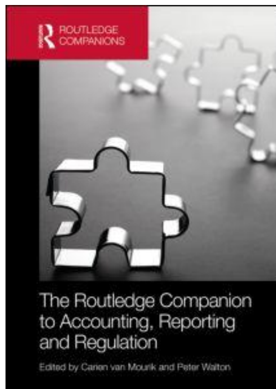

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The Application of IFRS Across Different Institutional Environments

Bernard Raffournier

The International Financial Reporting Standards (formerly known as International Accounting Standards) are now widely used in several parts of the world. This chapter describes how these standards have diffused and evaluates their impact on accounting quality, as well as their economic consequences. It also examines why, despite the adoption of common accounting standards, certain national characteristics persist, before considering several issues that the IASB will have to face in the near future.

1. The diffusion of IFRS

1.1 The pre-2005 period

Although the IASC was created in 1973, international accounting standards were rarely applied until the beginning of the 2000s. The reason is that in each country IAS were in conflict with domestic GAAP, whose application was mandatory. To circumvent this obstacle, some companies tried to prepare financial statements complying with both sets of standards. They took advantage of options allowed by national GAAP to select treatments required by international standards, which allowed them to claim compliance, at least partial, with IAS/IFRS. This possibility was suppressed in 1999, with the adoption of revised IAS 1 which stipulates that, for periods starting on or after 1 July 1998, financial statements cannot be described as complying with IAS if they do not comply with all the requirements of each applicable standard.

The other solution available to firms that were anxious to apply IAS/IFRS was to prepare accounts complying with these standards in addition to official financial statements established according to domestic GAAP. This option has rarely been used, probably due to its cost and the confusion that it would have generated among users of financial statements. Indeed, it would be difficult to explain that the same economic reality can result in two distinct pictures whereas each set of standards is aimed at giving a true and fair view of the enterprise. Rapidly it became clear that the diffusion of IAS/IFRS into the financial reporting practices of enterprises would require a change in national regulations. This change took two forms.

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In 2000, the International Organization of Securities Commissions (IOSCO) recommended that its members allow large companies to use IAS in the preparation of their financial statements for cross-border offerings and listings. Although this recommendation was not fully unrestricted (national stock exchanges could still require reconciliations with local GAAP), this initiative played a major role in the widespread acceptance of IAS at the world level. In application of this directive, the London Stock Exchange and the Frankfurt Stock Exchange authorized foreign issuers to apply IAS instead of national rules as soon as 2000. Similar dispositions were adopted in France and Italy but they never entered into force (Delvaille *et al.,* 2005).

It is in Europe that the main initiatives toward IFRS adoption took place. This geographical area has long been characterized by a large variety of accounting rules and practices, which is a consequence of the coexistence of the two major accounting traditions, Anglo-Saxon and Continental European. In this context, the need for an international harmonization of accounting practices was particularly imperious. The first step toward IAS adoption took place in 1995, when the European Commission decided to cooperate with the IASC in order to achieve conformity with the IAS and the EU Directives (Haller, 2002). The practical consequence was the introduction, in several member states, of provisions allowing the use of IAS as an alternative to local GAAP for the preparation of the consolidated financial statements of listed companies.

This initiative resulted in a slight increase of companies using IAS. According to a study based on the 1999 annual report (i.e. after the introduction of the requirement that companies claiming for conformity with IAS must comply with all IAS requirements), the rate of IAS adoption among EU listed companies was 4.5 per cent (Cuijpers and Buijink, 2005). However, most IAS adopters were in Germany (44 per cent) and Austria (20 per cent). By contrast, UK companies were particularly reluctant to adopt IAS.

A necessary condition for companies to voluntarily comply with IFRS is that the expected advantages outweigh the costs of adoption. Due to the pre-eminence they give to fund providers, IAS/IFRS clearly pertain to the Anglo-Saxon view of accounting. By switching to IFRS, companies from Continental Europe could hope that the reliability of their financial statements will be improved, which should attract more foreign investors and reduce their financing costs. British companies were less enthusiastic given the relative proximity of UK GAAP and IFRS.

Nevertheless, all companies of the same country were far from adopting IFRS spontaneously, which suggests that a voluntary change of accounting standards was contingent upon individual incentives. In order to identify these incentives, Dumontier and Raffournier (1998) compared the characteristics of Swiss companies that were applying IAS with those that were using domestic GAAP. The Swiss case is particularly favourable to such a study because Switzerland has long been a poorly regulated country with regard to accounting. It was only in 1984 that the national standard setting body was created and its standards were very permissive. In this context, the advantages that could be expected from IAS adoption were substantial. The empirical study based on data from 1994 reveals that companies applying IAS were larger, more internationally diversified, less capital intensive and had a more diffuse ownership.

Cuijpers and Buijink (2005) conducted a similar research at European level. Comparing firms that were using IAS in 1999 with those using local GAAP, they found that IAS adopters were larger, more likely to be listed on a US stock exchange, and had more geographically dispersed operations. These results are confirmed by Renders and Gaeremynck (2007) who found that in Europe, large companies with a Big 5 auditor, a low ownership concentration and whose securities are listed on more stock exchanges had a higher rate of early compliance with IFRS. Taken together, these studies suggest that pressures from outside markets are a key driver for voluntary IAS/IFRS adoption.

Contrary to previous studies that are based on listed firms, Francis *et al.* (2008) examined IAS adoption by private companies. Their study uses data collected in late 1999 and early 2000 and involves 3,722 entities from 56 countries. IAS adopters are characterized by higher growth opportunities, more foreign ownership and greater external financing needs. These firms also are larger, more engaged in exports and more often organized as limited liability corporations. These results must nevertheless be taken with prudence given the high proportion of emerging countries in the sample (the most represented countries are Thailand, Russia, Poland, Estonia, Brazil and Turkey). It is not obvious that incentives to IFRS adoption are the same in emerging and more developed economies.

Because incentives to IFRS adoption are mainly individual, it could not have been expected that all European companies would spontaneously change their accounting standards, even after the removal of institutional obstacles that remained in some countries. On the contrary, the acceptance of IFRS-based financial statements by European stock exchanges resulted in two-tier financial reporting with, in the same country, the coexistence of companies applying IAS and others that were still using domestic GAAP. Moreover, as IAS adopters were concentrated in a limited geographical area (Germanic countries essentially), comparisons between firms from different parts of Europe had not really been made easier. The European Commission therefore came to the conclusion that the standardization of financial information that was a prerequisite to the establishment of the Single Market made it necessary to impose the adoption of IFRS. As a result, the Commission decided in 2000 that all EU listed companies would have to prepare their consolidated financial statements in conformity with IFRS from 2005 onwards (Commission of the European Communities, 2000).

1.2 The situation since 2005

The EU decision to make IFRS mandatory for all European listed companies was a major historical event since its objective was to standardize the financial reporting practices of more than 7,000 firms. It also made IFRS the most widely accepted accounting standards in the world. This decision considerably reinforced the legitimacy of IFRS and definitively established the IASB as the unchallenged reference for standard setting.

The European example was followed by several major countries which in turn adopted the IFRS so that, at the beginning of 2012, 92 countries require the use of IFRS for their domestic listed companies (Table 15.1). Nevertheless it is worth noting that, in some cases, standards that have been adopted as IFRS are not exactly in accordance with those published by the IASB.

Table 15.1 Acceptance of IFRS by countries (as of February 2012)

	Domestic listed companies	*Domestic unlisted companies*
IFRS required for all	92	25
IFRS required for some	5	30
IFRS permitted	25	44
Subtotal	122	99
IFRS not permitted	31	36
Total	153	135

Source: Deloitte (www.iasplus.com/country/useias.htm)

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This widespread acceptance of IFRS substantially modified the balance of power between the IASB and the US authorities (SEC and FASB). Although the use of IFRS is still prohibited for US firms, the Securities and Exchange Commission (SEC) decided in 2008 that foreign companies preparing their financial statements in accordance with IFRS will no longer have to reconcile their accounting figures with the amounts that would have been obtained using US GAAP. This decision was effective for periods ending after 15 November 2007.

Countries that adopt IFRS transfer their national standard setting to a supranational private organisation on which they generally have little influence.[1] They do so because they expect advantages from this loss of sovereignty. According to the IASB, the objective of financial reporting is 'to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity' (IASB, 2010 p. 9). This acknowledged pre-eminence of fund providers contrasts with the Continental European view of accounting under which financial statements must satisfy the information needs of a variety of stakeholders (shareholders, creditors, employees, customers, the state, etc.).

Due to this financial orientation, the advantages of IFRS adoption should be particularly substantial for developing or transitional economies and countries that do not share the Anglo-Saxon view of accounting. Through the adoption of IFRS, emerging economies can inexpensively endow themselves with a set of recognized standards that are in line with the investors' needs, which should help them collect funds from private investors or public international organisations. For developed countries, the replacement of former domestic GAAP by more investor-oriented accounting standards should increase the international visibility of their firms.

According to Hope *et al.* (2006), two categories of countries should have incentives to adopt IFRS: those with relatively weak investor-protection mechanisms and those that are opening up their capital markets. For the former, IFRS adoption should reduce the expropriation risk by majority shareholders. For countries of the latter category, the adoption of IFRS should increase access to financial markets and attract new investors. The empirical analysis support these predictions: countries that have adopted IFRS prior to 2005 or 2006 exhibit poorer disclosure rules and anti-director rights; they also provide better access to their stock market for international investors than jurisdictions that did not adopt IFRS.

Judge *et al.* (2010) used a sociological approach. In accordance with the institutional theory, they consider that the adoption of IFRS by many jurisdictions throughout the world may be a consequence of political or economical pressures from international bodies such as the International Monetary Fund (coercive isomorphism). IFRS adoption may also be motivated by a wish of imitation (mimetic isomorphism) or be a consequence of the sharing of common values by deciders in different countries (normative isomorphism). Their empirical analysis based on 132 countries reveals that IFRS-adopting jurisdictions tend to have a higher level of foreign aid, import more than other countries and have a more highly educated population. The authors interpret these findings as supporting the three forms of isomorphism.

2. The effects of IFRS adoption on accounting quality

2.1 The comparability of accounting figures

The prime objective of IFRS adoption is to increase the cross-border comparability of accounting figures. In 2000, the European Commission wrote:

> There are currently many different financial reporting rules and differing interpretations based on distinct traditions within the European Union. Unless reform is undertaken,

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> inconsistencies – many of them of major importance – will continue. European financial reporting will remain fragmented, thereby hampering the development of a deep liquid single EU capital market (Commission of the European Communities, 2000, p. 3).

In as much as IFRS generally admit less options than domestic GAAP that they have replaced, their adoption should also result in an increase of comparability within each country. Strangely, there is still little evidence on the impact of IFRS adoption on within and between country reporting comparability.

To date, the most comprehensive study is that of Jones and Finley (2011). It measures the evolution of the dispersion of accounting numbers for a sample of European and Australian firms before and after the mandatory adoption of IFRS by both countries. The authors calculated about twenty financial ratios for the years 2006 and 1994–2004 and observed that, for most of them, the coefficient of variation was significantly lower in 2006 than in the pre-IFRS period. This suggests that IFRS adoption has reduced the dispersion of accounting figures and thus increased within-country comparability.

In a study involving companies from the UK and Australia, Cairns *et al.* (2011) tested whether mandatory IFRS adoption has improved within and between country comparability for a set of policy choices requiring or permitting fair value measurement. The evidence is mixed as the authors conclude that within and between country comparability has increased for property, plant and equipment, derivatives and share-based payments, but decreased for financial assets and liabilities due to the use of the fair value option instead of amortized cost.

2.2 Earnings management

IFRS are probably the most complete and detailed set of accounting standards after US GAAP. As with any standard, they cannot be applied to practical cases without resorting to estimations, in particular where impairment of assets or provisions are concerned. Managers can use this relative incompleteness of accounting standards to manipulate accounting figures, particularly earnings, which gives rise to what is generally called 'earnings management', a behaviour defined by Healy and Wahlen (1999, p. 368):

> Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

Earnings management can take several forms. Some manipulations are purely one-off, as those aimed at increasing earnings prior to the issuance of securities, or meet a given level of performance (analysts forecasts, for example). Other manipulations are multi-periodic, as income smoothing whose purpose is to reduce earnings volatility and accordingly the perceived risk of securities, or 'big bath', a manipulation consisting in recording large losses in a particular year to generate hidden reserves that can be recognized as profits in subsequent years.

Earnings management is not punished with the same strength in all jurisdictions. In some countries, it is permitted, or even encouraged, as in the Germanic area (Germany, Switzerland, Austria) where, before IFRS adoption, companies could legally create hidden reserves. In most non-Anglo-Saxon countries, the strong link between accounting and tax rules creates incentives to manipulate earnings, at least in parent-only financial statements. For the IASB on the contrary, earnings management cannot be accepted, as it is in contradiction to the objective of 'faithful representation' (IASB, 2010, p. 18). Outside the Anglo-Saxon world, one should thus

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observe less earnings management after the switch to IFRS. Several studies have tried to test this prediction in diverse environments.

Barth *et al.* (2008) measured the earnings management practices of a sample of companies that have voluntarily adopted IFRS between 1994 and 2003. They observed that earnings manipulations were significantly less frequent after IFRS adoption than before. It is worth noting that, although the study covers 21 countries, 72 per cent of sample firms come from Switzerland, Germany or China. Van Tendeloo and Vanstraelen (2005) conducted a study based on German data only. Contrary to Barth *et al.* (2008), they did not find differences with regard to earnings management for firms that had adopted IFRS and those that were still using domestic GAAP in the years 1999–2001.

Studies on mandatory IFRS adoption are not more corroborating. In a research covering Australia, France and the UK, Jeanjean and Stolowy (2008) do not note a decline in the pervasiveness of earnings management after the introduction of IFRS. For France, they even find an increase of earnings manipulations, contrary to Zéghal *et al.* (2011) for whom IFRS adoption is associated with a decrease in earnings management practices.

Results obtained at the European level are also inconclusive. On the one hand, a study by Callao and Jarne (2010) on 1,408 firms from 11 EU member states shows that earnings management has intensified since the adoption of IFRS. On the other, Chen *et al.* (2010) report a decrease in earnings management towards a target and a lower magnitude of discretionary accruals but more earnings smoothing after IFRS adoption. This latter research suggests that the transition to IFRS may have different effects on various types of earnings management.

2.3 Timeliness

To be useful to decision taking, accounting information must not only be relevant, it should also be available in due time. Timeliness is thus a key dimension of accounting quality. According to the IASB (2010, p. 21) 'timeliness means having information available to decision-makers in time to be capable of influencing their decisions'. This definition is too general for empirical studies. The proxy generally used to make it operational is the frequency of large losses. This choice is based on the assumption that managers are reluctant to report losses. Rather than recognizing them as they occur, they would probably prefer to defer losses to future periods, with the hope that they will be offset by future earnings. Because IFRS are more investor-oriented than most non Anglo-Saxon domestic GAAP, their adoption should result in more timely accounting information, that is in a higher frequency of large losses.

In their study on voluntary IAS adoption, Barth *et al.* (2008) provide evidence consistent with this prediction. Adversely, Chen *et al.* (2010) in the European Union and Paananen and Lin (2009) in Germany found that the adoption of IFRS was associated with a lower percentage of losses, which suggests that IFRS have not improved the timeliness of accounting data.

2.4 Value relevance

According to the IFRS and, more generally, the Anglo-Saxon view of accounting, the purpose of accounting is to provide information useful for decision taking by investors. If, as expected, accounting data are relevant for company valuation, they should be highly correlated with market values. Accordingly value relevance is often defined as the ability of accounting data to summarize information impounded in market prices (Francis and Schipper, 1999). Value relevance can thus be assessed by regressing accounting data with their market equivalents. Two

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types of models are currently used. Price models relate equity to the market value of shares with an equation such as:

$$P_{it} = \alpha_i + \beta_{1i} B_{it} + \varepsilon_{it}$$
$$\text{or } P_{it} = \alpha_i + \beta_{1i} B_{it} + \beta_{2i} E_{it} + \varepsilon_{it}$$

where P_{it} = price of share i at time t

B_{it} = book value per share i at time t

E_{it} = earnings per share i at time t

Alternatively, return models measure the association between earnings per share and market returns:

$$R_{it} = \alpha_i + \beta_{1i} E_{it} + \varepsilon_{it}$$
$$\text{or } R_{it} = \alpha_i + \beta_{1i} E_{it} + \beta_{2i} \Delta E_{it} + \varepsilon_{it}$$

where R_{it} = market return of share i at time t

E_{it} = earnings per share i at time t

ΔE_{it} = change in earnings per share i at time t

In both cases, coefficients β capture the value relevance of each accounting figure, whereas the coefficient of determination of the equation (R^2) indicates the value relevance of the whole set of accounting data included in the equation.

Since IFRS are more market-oriented than most previous national GAAP, the value relevance of accounting data should be higher after their adoption. As for other dimensions of accounting quality, the evidence is mixed. On the one hand, Barth *et al.* (2008) find that companies that have voluntarily adopted IFRS exhibit higher value relevance after adoption than before. Similar results were obtained for mandatory IFRS adoption in China (Liu *et al.,* 2011) and Romania (Filip and Raffournier, 2010). On the other hand, Aubert and Grudnitski (2011) find no increase in value relevance in any EU country after IFRS adoption. Karampinis and Hevas (2011) obtain a similar result in the case of Greece.

In a study covering five major European countries, Devalle *et al.* (2010) note that the impact of IFRS differs according to the stock exchange considered. The value relevance of accounting data increased due to the adoption of IFRS in France and the UK, but decreased in Germany, Spain, and Italy. Evidence of a negative impact of IFRS on value relevance in Germany was also found by Paananen and Lin (2009).

No clear conclusion can be drawn from the results of empirical studies. In some countries, the quality of accounting information seems to have increased after IFRS adoption, whereas in other jurisdictions, the change had no impact. A possible explanation of this conflicting evidence is that certain domestic GAAP were already close to IFRS, whereas others were very different from IASB standards.

3. The economic consequences of IFRS adoption

In the EU, the underlying objective of IFRS adoption was to make European securities more attractive to extra-European investors and allow the growth of European stock exchanges which, at the beginning of the century, were around half the size of US capital markets (Commission of the European Communities, 2000). The adoption of IFRS was expected to reduce information

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processing costs faced by foreign investors by making it less costly to analyze foreign financial statements. Several studies have tried to evaluate the impact of IFRS adoption on the financial market and foreign investments.

3.1 Consequences on capital markets

3.1.1 Information asymmetry

A crucial market characteristic is informational efficiency, i.e. the capacity of prices to reflect all available information at any time. When information is unequally spread over participants, those who have superior information may use it to obtain a better price at the expense of other investors. Information asymmetry is thus detrimental to market efficiency.

To the extent that IFRS require larger disclosure and are more investor-oriented than most national GAAP they replace, their adoption should result in a decrease of information asymmetry on the concerned financial markets. Several authors have tried to test this prediction. As information asymmetry cannot be directly observed, these studies are based on proxies. The most commonly used proxy is the bid–ask spread, i.e. the difference between the bid price and the asked price of a security at a given point of time. Bid–ask spread can be interpreted as a measure of information asymmetry in as much as it should theoretically be nil if buyers and sellers had the same information regarding future earnings.

In Germany, Gassen and Sellhorn (2006) showed that companies that voluntarily adopted IFRS between 1998 and 2004 experienced a sharp decline in bid–ask spread. Similar results were obtained by Fabiano (2006) in Switzerland. With regard to mandatory adoption, a study by Platikanova and Nobes (2006) covering 15 European countries reveals a significant fall in bid–ask spread in 2005, as compared to 2003. Nevertheless, there are important differences among countries, which suggests that the impact of IFRS adoption on information asymmetry depends also on national characteristics.

3.1.2 Analysts forecasts

IFRS adoption should facilitate the work of financial analysts. If, as expected, the switch to IFRS results in lower information asymmetry, more timely accounting information and less earnings management, forecasting future earnings should be easier after the change of standards. Analyst forecasts should thus be more accurate and less dispersed after IFRS adoption than before. Several empirical studies have tried to test these predictions.

Ashbaugh and Pincus (2001) examined 80 non-US companies claiming to comply with IAS in the years 1990–93. They observed that, for these firms, the switch to IFRS was associated with a significant decrease in analyst forecast errors. Nevertheless, this finding must be interpreted with prudence given that, at the time of the study, firms could claim for IAS compliance without respecting all IAS requirements.

Two recent studies concern the adoption of IFRS by the European Union in 2005. Jiao *et al.* (2012) document increased forecast accuracy and less dispersion after the switch to IFRS. Byard *et al.* (2011) obtain similar evidence but only for firms domiciled in countries with specific characteristics. A wider study including the EU as well as other countries that have made IFRS mandatory (Australia, Hong Kong, Philippines, Singapore, South Africa, Switzerland) shows that IFRS adoption improves the accuracy of forecasts made by foreign analysts but not those of domestic professionals (Tan *et al.,* 2011). This finding is interesting as it suggests that forecast quality depends less on accounting standards than on the analysts' proximity with enterprises.

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3.1.3 Market liquidity

The increased quality of accounting information resulting from IFRS adoption, in particular the expected reduction in information asymmetry, should reassure market participants and incite them to invest more in listed companies. As a result, the security market should become more liquid. In the EU, increasing the liquidity of the Single Market was acknowledged as the primary motivation of IFRS adoption (Commission of the European Communities, 2000).

Daske *et al.* (2008) examined the effect of mandatory IFRS adoption in 26 countries. Using four proxies for market liquidity, they found that market liquidity increased after IFRS adoption. In the same vein, Landsman *et al.* (2012) report that firms from countries that have adopted IFRS experience a greater increase of abnormal trading volume in the days surrounding earnings announcements than firms from other countries.

Globally, empirical studies tend to show that IFRS adoption has reduced information asymmetry, increased market liquidity and made earnings forecasts easier. It remains to be seen whether this improvement in the functioning of markets has benefited companies.

3.2 Consequence on foreign investments

According to financial theory, investors should invest in foreign companies to diversify their risk internationally. Despite that, there is evidence that most portfolios are overinvested in domestic securities.[2] This home bias is generally interpreted as a consequence of information costs that investors have to face when they invest in foreign countries. Beneish and Yohn (2008) distinguish three types of information costs that are associated with foreign investment:

- information processing costs;
- costs resulting from the uncertainty about the quality of financial reporting; and
- about the distribution of future cash flows.

Information processing costs are the costs of becoming familiar with the financial statements of foreign companies. These costs are reinforced by the investors' perception that they are less competent in interpreting financial statements of foreign companies. The more foreign accounting standards deviate from the investor's domestic GAAP, the higher these costs are. The adoption of common internationally recognized accounting standards as IFRS should reduce the cost of analysing foreign financial statements and make foreign investors more confident in their ability to correctly interpret these statements. As IFRS are recognized as high quality standards, of higher quality at least than most national GAAP they have replaced, their adoption should also reduce costs associated with the uncertainty about the quality of foreign financial statements.

The third category of costs results from the view that domestic investors have an information advantage over foreigners with regard to the distribution of companies' future cash flows. This argument reflects the idea that local investors are better informed about the risk-return characteristics of domestic securities because of higher proximity with local companies. Given that the whole set of information available on a company largely exceeds what is likely to be disclosed in financial statements, IFRS adoption should normally not challenge the informational advantage of local investors. Nevertheless, to the extent that IFRS disclosure requirements are higher than those of most former local GAAP, IFRS adoption may result in public disclosure of information that otherwise would not be available to foreign investors.

The switch to IFRS should reduce the information costs of foreign investors and consequently incite them to invest more outside their boundaries. Empirical studies are consistent with this

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prediction. In a study covering 29 countries, Covrig *et al.* (2007) found that average foreign mutual fund ownership was significantly higher among firms that had voluntarily adopted IAS. They also found that the level of foreign investments was particularly high among IAS adopters located in poor information environments. Similarly, Shima and Gordon (2011) document that US foreign equity investment is associated with IFRS adoption, at least in strong regulatory environments. Concerning debt financing, Kim *et al.* (2007) report that voluntary IAS adopters attract more foreign lenders from the international loan market than firms that are using domestic GAAP.

3.3 Consequence on the cost of capital

The increased quality of accounting information and the reduction in information asymmetry resulting from the switch to IFRS should lower the perceived risk of securities. As a consequence, the claims of investors should, *ceteris paribus*, be less after IFRS adoption than before. The switch to IFRS should thus be associated with a decrease in the financing cost of companies. From a firm's point of view, this impact on the cost of capital is probably the main criteria measuring the benefits of IFRS adoption.

The cost of capital is the average cost of all financings used by a company. It encompasses the cost of equity capital and the cost of borrowings. Nevertheless, most studies have focused on the first component. In Europe, neither Daske (2006) nor Cuijpers and Buijink (2005) found evidence of a lower cost of equity capital for voluntary IAS adopters. By contrast, Daske *et al.* (2008) and Li (2010) document a decrease in firms' cost of equity capital after IFRS mandatory adoption. The only study on the cost of debt was made by Kim *et al.* (2007). It reports that lenders charge significantly lower loan rates to IAS adopters than they do to non-adopters.

4. IFRS adoption and national characteristics

Several empirical studies on the effects of IFRS adoption document important country differences. This suggests that the impact of accounting standards is contingent on the context in which they are applied, in particular on local institutional characteristics. Before considering the influence of national features, it is useful to examine the level of IFRS compliance in countries that have adopted IASB standards.

4.1 The degree of IFRS compliance

It could be expected that mandatory adoption of IFRS in Europe and some other parts of the world would result in a standardization of accounting practices in the concerned countries. As mentioned above, IFRS adoption seems to have improved the international comparability of financial statements. Nevertheless, the standardization process has not been complete, as evidenced by empirical research.

Several studies document significant noncompliance with the disclosure requirements of IFRS among firms that voluntarily adopted IFRS. Hodgdon *et al.* (2008), for example, examined the level of compliance for a sample of firms that claimed to comply with the disclosure requirements of IFRS in 1999–2000. They found an average compliance score of 68 per cent and an extreme dispersion of observations, with score values ranging from 4 per cent to 96 per cent. The decision to make IFRS mandatory did not solve the problem, as Tsalavoutas (2011) shows that, in 2005, certain IASB standards were still poorly respected in Greece, in particular those that differed the most from previous Greek GAAP.

Several authors examined whether noncompliance has an impact on the benefits resulting from IFRS adoption. Hodgdon *et al.* (2008) in particular have shown that analyst forecast errors

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are inversely related to the level of compliance with IFRS. But it is probably Daske *et al.* (2007) who made the most comprehensive study on this issue. These authors examined a set of companies that had voluntarily adopted IAS/IFRS between 1998 and 2004. Using several measures of IFRS compliance, they split the sample firms into two categories: serious and 'label' adopters. Only the former exhibited a decrease in their cost of capital and bid–ask spread following the switch to IAS/IFRS. What is particularly interesting in this finding is that it suggests that market participants are able to distinguish between firms that really conform to IFRS and those that comply only superficially with these standards. The rest of this section is devoted to an examination of national characteristics that may create incentives to fully comply with IFRS.

4.2 The legal and regulatory environment

Legal systems can be classified in two categories: common law and code (or civil) law.[3] These categories differ in the importance they give to the rights of private property owners versus the state. Code law is traditionally viewed as emphasizing the rights of the state to a higher degree than common law (Beck *et al.,* 2003). Numerous studies document the influence of the legal system on accounting quality. Ball *et al.* (2000), for example, find that accounting income is more timely in common law than in code law countries. Nevertheless, the code/common classes are not homogeneous and partitioning countries with reference to this only criterion would hide important differences within each category. It is thus preferable to abandon the classical code/common law dichotomy to more precisely distinguish the diverse dimensions of legal systems.

One of these dimensions is shareholder protection. The interests of shareholders are not equally protected in all legal systems (La Porta *et al.,* 1998). Because non-compliance with IFRS is detrimental to shareholders, it should be less frequent in countries characterized with a high level of shareholder protection. Moreover, in jurisdictions that actively protect shareholders, domestic GAAP were probably less different from IFRS than in other countries. In these jurisdictions, the transition to IFRS has probably represented a less fundamental change than in countries with low shareholder protection. One can thus predict that compliance with IFRS is higher in environments characterized with high investor protection.

Strong legal rules are a necessary condition to guarantee that the rights of shareholders are protected, but not a sufficient one. Legal rules may remain largely ineffective without proper enforcement. Furthermore, a solid system of legal enforcement can also substitute for weak rules since active and well-functioning courts can rescue investors abused by managers (La Porta *et al.,* 1998). The influence of law enforcement is supported by numerous studies dealing with various aspects of accounting quality (e.g. Bushman and Piotroski, 2006; DeFond *et al.,* 2007). Assuming that a high level of law enforcement increases the likelihood that legal provisions aimed at protecting shareholders are really respected, a positive association between law enforcement and IFRS compliance can be expected. Consistent with this prediction, Daske *et al.* (2008) document that the increase in liquidity and equity valuations following mandatory IFRS adoption is restricted to countries with strict enforcement regimes.

4.3 Other influences

4.3.1 Corporate governance quality

Law is not the only source of protection for investors. Efficient corporate governance practices may also reduce the level of expropriation by insiders. Durnev and Kim (2005), for example, show that firms with better governance are valued higher on stock markets, especially where

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legal investor protection is weak, which suggests that efficient corporate governance practices may be a substitute for poor legal environments.

In recent years, the rights of shareholders have been considerably strengthened with the adoption of corporate governance rules. In a survey ordered by the European Commission, Gregory and Simmelkjaer (2002) identify 35 documents that qualify as corporate governance codes. They also note that most EU member states have at least one code document. In a limited number of countries (Germany and Sweden), corporate governance provisions have been included in company law, but in most European states they take the form of codes of best practices whose application is voluntary or enforced by stock exchange authorities.

There is a growing body of research on the influence of corporate governance characteristics on accounting quality. The proportion of outside directors in particular was found as being positively related to earnings timeliness (Beekes *et al.,* 2004) and negatively associated with earnings management (Klein, 2002). To the extent that IFRS adoption increases accounting quality, IFRS compliance and corporate governance characteristics should also be associated. More precisely, one can predict that firms subject to high quality corporate governance mechanisms exhibit higher levels of IFRS compliance. Unfortunately, this hypothesis has not yet been empirically tested.

4.3.2 Auditors

Many studies have investigated the impact of auditor type on various aspects of accounting quality. They generally report a positive association between accounting quality and the size of audit firm. The traditional interpretation is that large audit firms are more independent of their clients than smaller auditors. Accordingly, they can more easily oppose GAAP violations, earnings management or creative accounting.

Big 4 audit firms have largely anticipated IFRS adoption. Well before IFRS implementation, they developed training programmes and audit controls specifically for IFRS audits (Street, 2002). Since such investments are costly, smaller audit firms could not be expected to have the same level of IFRS expertise as Big 4, at least in the early years of IFRS application. In support of this argument, several studies document that compliance with IFRS is higher in companies audited by a large audit firm (Glaum and Street, 2003; Hodgdon *et al.,* 2009).

4.3.3 The financial system

It is traditional to oppose bank- and market-oriented financial systems. In the former, banks are the main providers of company financing, whereas, in the latter, companies generally prefer raising funds from the security market. In market-oriented countries, the large number of shareholders generates a high demand for accounting quality, in particular more timely incorporation of economic income in accounting earnings. Inversely, in bank-oriented countries, the demand for high-quality accounting data is lower because information asymmetry is more likely to be resolved through insider communications with management (Ball *et al.,* 2000). Since IFRS are supposed to provide information of better quality than most domestic GAAP, the demand for IFRS compliance should be higher in market-oriented financial environments than in bank-oriented countries. This conjecture has not yet been formally tested but several empirical studies provide evidence consistent with it. Leuz *et al.* (2003) and Burgstahler *et al.* (2006) for example have shown that earnings management is less prevalent in countries with large and highly developed equity markets than in bank-oriented economies.

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5. Issues for the future

Since the beginning of the twenty-first century, the IASB has emerged as the key player in international accounting standard setting. Its standards have been adopted or are on the point of being adopted by a large number of countries. Its only competitor, the US Financial Accounting Standard Board, seems to have given up the idea of imposing its standards beyond the US boundaries; it now works with the IASB on joint projects in order to arrive at convergence of US GAAP and IFRS, which should, at an undefined horizon, result in IFRS adoption by the US authorities. Despite these successes, the IASB is faced with several problems it will have to address in the next years in order to hold its authority.

5.1 The proliferation of 'local IFRS'

According to the IASB, a company cannot claim compliance with IFRS unless it complies with all the requirements of IFRS (IAS 1, § 16). Nevertheless several empirical studies provide evidence of partial compliance, in particular where enforcement mechanisms are insufficient or ineffective. However, noncompliance is not always a consequence of management opportunism. Even in countries that are claiming IFRS adoption, rules may exist that prevent full application of these standards. Moreover, some countries have developed local versions of IFRS that differ from IASB standards on specific points.

In some cases, new standards must pass an agreement process whose length is variable before being applicable. In the EU, IFRS are enforceable only after they have been approved by the European Commission. The agreement process gives political authorities the power to refuse any standard that could go against their interests or be unsuitable for the local context. The threat of non-adoption may also help them obtain changes in a standard project. By refusing to adopt the initial version of IAS 39, the EU obtained a revision of this standard (Bengtsson, 2011). Of course, only countries or groups of countries whose political or economical weight is substantial can effectively exert pressure on the IASB.

Rather than adopting IFRS as such, some countries preferred to integrate them into their own regulations. In some jurisdictions (Australia, New Zealand, Korea), IFRS have been copied with no significant change, so that domestic GAAP can be seen as 'IFRS-equivalents'. But in other cases (China, Philippines, Singapore), substantial differences remain. Sometimes also, IFRS have been taken as they stood at a point in time and no updating has since been made (Uruguay, Venezuela).[4]

The proliferation of local versions of IFRS is dangerous because it makes it possible for financial statements to be presented as complying with IFRS despite significant deviations from IASB standards. The 'IFRS-equivalent' concept itself is unclear, as there is no indicator that can be used to measure the degree of equivalence with IFRS and decide from what level the 'IFRS-equivalent' label may be granted. IFRS are unanimously recognized as high quality standards. It would be regrettable if their image were altered due to the proliferation of ersatz copies that would usurp their name. As the owner of the 'IFRS' brand name, the IASB would be well advised to oppose the development of more or less faithful imitations.

5.2 The resistance to IFRS

Despite their wide diffusion, IFRS are still subject to criticisms from practitioners, academicians and politicians. Some of them are technical, others are political. The former are based mainly on an alleged excessive use of fair value. IFRS are accused of resorting too much to fair value for valuation purposes. This criticism was particularly strong at the beginning of the last financial

crisis, when some observers did not hesitate to allege that IFRS played a significant role in the 2008 credit crunch. We will not discuss this point as many articles have been written on this issue (André *et al.,* 2009; Laux and Leuz, 2009; Magnan, 2009); moreover this book devotes a full chapter to fair value. We will thus focus on political criticisms that have rarely been taken up by the literature in English. These criticisms turn on the market orientation of IFRS and an alleged lack of legitimacy for the IASB.

5.2.1 The market orientation of IFRS

IFRS are representative of the Anglo-Saxon view of accounting which considers that the primary objective of financial reporting is to provide information useful to investors. This pre-eminence of funds providers is explicitly acknowledged by the new conceptual framework which stipulates that 'the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity' (IASB, 2010, § OB2).

In Continental Europe, especially in France, many people challenge this investor orientation. They consider that there are many potential users of accounting information (employees, suppliers, customers, the state, the society in general) and that accounting should not favour one category at the expense of others. More fundamentally, some people express the view that accounting reflects a certain conception of the enterprise (Burlaud and Colasse, 2011) and that recognizing investors as privileged users of financial reporting amounts to favouring them in the sharing of the wealth created by the firm (Chiapello and Medjad, 2009). Capron (2005), for example, notes that in Anglo-Saxon countries expenses are generally classified by function, which makes the calculation of value added more difficult than when they are classified by nature, as in most European countries. He fears that even if both presentations are presently admitted, the use of IFRS will progressively result in the extinction of the classification by nature and consequently delete the debate on value added sharing. Because of their investor orientation, IFRS are often perceived in Continental Europe as the Trojan Horse of financial capitalism.

5.2.2 The IASB legitimacy

For a long time, the IASB had only a proposal role; its standards served as a reference for the production of national GAAP but had no coercive nature. In the early 2000s, when some countries or groups of countries decided to make IFRS mandatory for listed companies, the IASB changed its status, switching from a simple technical organization to a supranational standard setter.

In the Anglo-Saxon world, this evolution did not generate strong opposition as it is usual in these countries for the state to entrust private organizations with the task of regulating technical issues. In Continental Europe by contrast, several voices were raised, blaming authorities for giving up a part of their sovereignty. Reactions to this privatization of standard setting were particularly strong in France and, to a lesser extent, in Germany, probably because in these two countries accounting regulation was previously endorsed by law (Chiapello and Medjad, 2009).

The IASB was criticized mainly for an alleged lack of legitimacy. According to Burlaud and Colasse (2011), the IASB is not legitimate because Board members are not democratically elected. In defence of the IASB, Gélard and Pigé (2011) retort that a democratic election is not the only way to acquire legitimacy. For them, IFRS take their legitimacy from the decision of the European Commission, a democratic entity, to endorse these standards.

The criticisms on legitimacy are reinforced by the domination that large audit firms exert on the IASB. As noted by Chiapello and Medjad (2009), most Board members are former auditors

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and the Big 4 are the primary IASB contributors in terms of expertise. Irrespective of their origin, IASB Board members have thus a common professional experience and an Anglo-Saxon accounting culture (Burlaud and Colasse, 2011), which makes them unable to faithfully reflect the variety of accounting traditions.

This controversy on IASB legitimacy highlights the opposition between two opposed views of accounting. In the Anglo-Saxon world, accounting falls within economics and the purpose of financial reporting is to reflect the economic reality as well as possible. As a technical matter, it is quite natural to leave its regulation to people with the highest technical expertise, i.e. professionals (chartered accountants). In Continental Europe, by contrast, accounting is at the heart of distributive mechanisms among stakeholders: shareholders, lenders, employees, the state, etc. (Chiapello and Medjad, 2009). Because wealth sharing is a political issue, financial reporting must be regulated by democratically elected representatives. It is for that reason that the main provisions of accounting regulation are included in the law. In Continental Europe, the intrusion of IFRS amounts to a cultural revolution that dramatically goes against the way financial reporting and accounting regulation are perceived. Because these beliefs are deeply anchored in national culture, criticisms of IFRS are not likely to weaken. The IASB should thus take them into account, notably by widening the professional origin of Board members, if it feels desirable to enhance public adherence to IFRS outside the Anglo-Saxon world.

5.4 The influence of politicians

As long as the IASB was a private organization whose decisions had no immediate consequence on the financial statements of companies it was not submitted to intense scrutiny from politicians. But, since it has acquired the status of standard setter in several countries, the IASB has had to face increased political pressures. The main evidence of these pressures is the decision taken in 2008 to allow the reclassification of certain financial instruments. According to IAS 39, the valuation mode of financial assets depends mainly on the category to which they have been allocated at acquisition: those considered as held for trading or available for sale being shown at fair value. Until then, the IASB had always opposed category changes, given the earnings management opportunities that these reclassifications would allow. In autumn 2008, the subprime crisis and the collapse of Lehman Brothers caused a crisis of confidence among market participants. As a result, the market price of most securities declined. Because many financial assets were measured at fair value, ratios used for bank regulation deteriorated, which prevented banks from lending funds and amplified the credit crunch. To limit the economic consequences of the crisis, the EU urged the IASB to modify its standard. In response, the IASB waived its due process procedure and urgently issued an amendment to IAS 39, allowing the reclassification of financial assets that had to be measured at fair value.

This decision was harmful to the IASB in as much at it provides evidence that the international standard setter is likely to give in to political pressures, provided they come from powerful institutions. Since then, political organizations such as the European Parliament and the G20 have stepped into the breach and claim to have their say in the elaboration of IFRS and IASB functioning (Bengtsson, 2011). The IASB independence vis-à-vis politicians is now called into question. It is all the more regrettable since political independence constitutes one of IASB main assets. If so many countries have left the IASB to elaborate their accounting standards, it is precisely because it is an international organization that was not submitted to the influence of some country or other. One cannot imagine for example that China would have adopted US GAAP or the European Directives. Some detractors of IFRS now take advantage of this precedent to argue that the IASB is under the influence of the EU and that IFRS are in fact European standards, which of course considerably

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reduces their chance of being adopted elsewhere, particularly in the US. If the IASB intends to keep its status as a unique international standard setter, it should reassert its independence from any political power and reaffirm that its unfortunate decision of 2008 will be unique.

Notes

1 Only the US, the European Union and some major countries can, through their direct or indirect representatives on the Board, really influence IASB decisions.
2 Ahearne *et al.* (2004) for example document that by 2000, US investors held approximately 88 per cent of their funds in US equities.
3 Common law has an English origin, which explains that common law countries are members of the former British Empire. In code law countries, the legal system was inspired by France, Germany or Scandinavian states (La Porta *et al.,* 1997).
4 This information is extracted from Deloitte's IASPlus website: www.iasplus.com/en/resources/use-of-ifrs.

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