IFRS ADOPTION AROUND THE WORLD - A BRIEF LITERATURE REVIEW[1]

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Abstract:
Our paper aims to provide an updated description of the process of IFRS adoption in the E.U. and worldwide, pointing out its effects on the information presented in financial statements, on the markets efficiency and on the accounting harmonization. In order to achieve our goal, we have analyzed approximately 40 academic articles, published between 2000 and 2012, indexed in international databases, such as Science Direct, Emerald and ProQuest. Also, we have tried a classification of these papers according to the country analyzed in each of them, making a comparative analysis between the IFRS adoption effects in Code and Common Law countries.

Key words: *International Financial Accounting Standards, International accounting harmonization, IFRS adoption, effects, financial statements*

JEL classification: M41, M48

There is an enormous amount of literature concerning the process of international accounting harmonization and more recently, that of convergence. The most significant role in achieving international convergence is played by the International Accounting Standards Board (IASB). It is concerned with the development of accounting standards to be applied globally for increasing the international comparability of the financial information. Many countries intend to adopt International Financial Reporting Standards (IFRS) or make their national regulations converge with IFRS (Larson and Street, 2004, p. 91, Nobes, 2008, p. 1).

Research methodology

Our paper aims to provide an updated description of the process of IFRS adoption in the E.U. and worldwide, pointing out its effects on the information presented in financial statements, on the markets efficiency and on the accounting harmonization. The research methodology used to develop the article contains only qualitative methods. The documentation (literature review) and comparative analysis are completed in our approach with inductive and deductive reasoning. We have analyzed approximately 40 academic articles, published between 2000 and 2012, indexed in international databases, such as Science Direct, Emerald and ProQuest. Also, we have tried a classification of these papers according to the country analyzed in each of them, making a comparative analysis between the IFRS adoption effects in Code and Common Law countries.

Code law and Common Law countries' accounting systems

The Code versus Common Law partition, which is popular in the literature, is based on the expectation that the valuation role of earnings should be more important in

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shareholder as opposed to stakeholder economies. (La Porta et al., 1998) provide the first investigation of the legal system's effect on a country's financial system. They find that common law countries have better accounting systems and better protection of investors than code law countries. In Common Law countries (UK., Australia, Ireland), accounting standards are set by private sector bodies and the purpose of standard setting is to satisfy the information needs of investors because the main source of companies financing is the financial markets. The accounting system (Anglo-Saxon System) of these countries is less rigid, being based on traditions and customs and is independent of taxation. In Code Law countries (especially Germany, France, Belgium, Italy, Spain, etc.), standards are influenced by governments and accounting serves as a measure to divide profits between stakeholder groups. The accounting system of these countries (Continental System) is characterized by the strong "legislative" tradition, the strong link between accounting and taxation, the limited influence of the accounting professionals, because firms significantly recourse to bank financing and, finally, by the fact that the state is the primary recipient of the financial statements (Nobes, 1981). Code Law GAAP are also characterized as conservative (Jermakowicz and Gornik-Tomaszewski, 2006, p. 186). The IFRS have an Anglo-Saxon origin and their adoption resulted in a greater change in accounting statements for Code Law countries.

Some effects of IFRS adoption around the world

Currently, over 100 countries have recently moved to IFRS reporting or decided to require the use of these standards in the near future and even the U.S. Securities and Exchange Commission (SEC) is considering allowing U.S. firms to prepare their financial statements in accordance with IFRS. Moreover, it is estimated that until 2012 around 150 countries will adopt IFRS (IFRS Foundation, 2011). At the EU level, as a consequence of the provisions of Regulation 1606/2002 on the application of international accounting standards, since 2005, the enterprise groups listed on a stock exchange in Europe must prepare their consolidated financial statements in accordance with IFRS. This change in accounting systems had a large impact on the information environment, since prior to 2005, companies followed a variety of country-specific Generally Accepted Accounting Principles.

International accounting literature provides evidence that the effects of IFRS adoption involve three elements: the information presented in financial statements, the markets efficiency and the accounting harmonization. It has been argued that IFRS adoption improves the functioning of global capital markets by providing comparable and high-quality information to investors (Barth, 2008) and that IFRS promise more accurate, comprehensive and timely financial statement information than local general accepted principles (LGAAP), particularly if the standards they replace have been influenced by national legal, political and taxation agendas (Ball, 2006).

Because, even before IFRS became mandatory, many firms around the world have voluntarily adopted or switched to IFRS, a first category of analyzed studies identify ***the effects of voluntary adoption***. (El-Gazzar et al., 1999) reports that firms voluntarily adopting IFRS are those seeking to access foreign capital, improve customer recognition or reduce political costs. (Lang et al., 2003) note that firms electing to adopt IFRS early are those with fewer reconciling items. (Cuijpers and Buijink, 2005) find that the differences in the implied cost of capital are insignificant across LGAAP and IFRS firms in the European Union. They document a positive effect of non LGAAP adoption on analyst following, but fail to find evidence of a lower cost of capital for non LGAAP adopters. However, by comparing "early" and "late" adopters, they find some evidence that suggests that benefits take some time to fully materialize. Consistent with the prior paper, (Ashbaugh and Pincus, 2001) show that analyst forecast errors are positively related to differences in accounting standards between IFRS and various

LGAAP, and that the accuracy of these forecasts improves after firms adopt IFRS. (Covrig et al. 2007) document that foreign mutual fund ownership is significantly higher for IFRS adopters compared to local GAAP firms, particularly for firms from poorer information environments and with lower visibility. (Daske et al., 2007) classify firms into "label" and "serious" adopters using changes in firms' underlying reporting incentives and actual reporting behavior, and then analyze whether capital markets respond differently around IFRS adoptions. They find that, on average, voluntary IFRS adoptions are not associated with capital market benefits, especially when compared to other forms of commitment such as cross-listing in the U.S. Also, they find an increase in market liquidity and a decline in the cost of capital for "serious" adopters. These benefits are likely attributable to broader changes in firms' commitment to transparency, and not just IFRS. (Barth et al., 2006) find that the firms that voluntarily adopted IFRS up to 2003 exhibits less earnings management, more timely loss recognition and more value relevance of earnings, all of which they interpret as evidence of higher accounting quality. They find that after IAS adoption, firms have higher variance of changes in net income and in cash flows, higher correlation between accruals and cash flows, lower frequency of small positive net income and higher frequency of large losses.

Other papers examine the ***consequences of mandatory IFRS reporting around the world***. (Capkun et al., 2008) study the effect on earnings relevance and timing of the mandatory transition of European firms to IFRS and found that this transition had a small but significant positive impact on total assets, total liabilities and the equity of the firms in their sample. Return on Assets (ROA) is significantly higher under IFRS than under LGAAP with the greater increase occurring in those firms with lower levels of ROA under LGAAP. This transition earnings management is present in all countries, but its level is highest in those countries with weaker legal institutions and higher levels of pre-transition earnings management. The value relevance of the book value of equity is limited to the LGAAP reports. (Aubert, Grudnitski, 2011) also identify significant positive differences in ROA for firms computed under IFRS and LGAAP in Belgium, Finland, France, Italy, the Netherlands, Sweden, Switzerland and the UK; only German and Norwegian firms exhibited a negative average significant in ROA difference between ROA calculated using IFRS and LGAAP. Defining impact in terms of market and financial reporting quality, they found a statistically significant relationship between accounting information and market returns for firms in Belgium, Finland, France, Greece, Italy, the Netherlands, Norway, Sweden and the UK. Support for the timeliness of accounting information was uncovered for firms in the same countries (except UK). Finally, evidence to support the proposition that accounting regimes produce quality discretionary accruals was found for firms from Finland, Greece, the Netherlands, Sweden and the UK. There was no statistical support for any of the samples that accounting information produced under IFRS was any more value relevant than the accounting information derived using LGAAP.

(Capkun et al., 2011) examines the impact of the accounting flexibility offered by IFRS 1 during the 2005 mandatory adoption of IFRS in the EU. They find that firms with large positive (negative) earnings under LGAAP were more likely to report negative (positive) LGAAP-to-IFRS earnings reconciliations. Subsequently, in reporting periods following the adoption of IFRS, firms that reported positive (negative) reconciliations were more likely to show a decrease (an increase) in earnings. They find no evidence of stock markets reacting to earnings management during the IFRS transition, but find strong evidence in support of CEOs managing earnings reconciliations to increase their compensation. (Daske et al., 2008) analyze the effects on market liquidity, cost of capital and Tobin's q in 26 countries using a large sample of firms that are mandated to adopt IFRS. They find that, on average, market liquidity increases around the time of the introduction of IFRS. They also document a decrease in

firms' cost of capital and an increase in equity valuations. In their opinion, the capital-market benefits occur only in countries where firms have incentives to be transparent and where legal enforcement is strong, underscoring the central importance of firms' reporting incentives and countries' enforcement regimes for the quality of financial reporting. Comparing mandatory and voluntary adopters, they find that the capital market effects are most pronounced for firms that voluntarily switch to IFRS, both in the year when they switch and again later, when IFRS become mandatory. (Devalle et al., 2010) identifies that the influence of earnings on share price increased following the introduction of IFRS in Germany, France, and the UK, while the influence of book value of equity decreased (except for the UK).

(Armstrong et al., 2010) investigates the European equity market reaction to 16 events associated with the adoption of IFRS in Europe. They find an incrementally positive reaction for firms with lower pre-adoption information quality and higher pre-adoption information asymmetry. They also document an incrementally negative reaction for firms domiciled in code law countries, which are likely to have weaker enforcement of accounting standards. Overall, their findings suggest that investors expected net benefits to IFRS adoption in Europe associated with increases in information quality, decreases in information asymmetry, more rigorous enforcement of the standards, and convergence.

In the literature there is evidence suggesting the ***difficulties or even the failure*** of the process of IFRS implementation: the lack of political will, the rooting in the local culture and a strong nationalism (Callao, et. al. 2007); the large differences between countries and the high costs for their elimination; the strong influence exercised of local traditions on the implementation of new concepts (such as "true and fair view"), the increased influence of the taxation (Larson and Street, 2004, p. 110). Also, against the uniform and consistent application of IFRS are the financing system the tax system and the legal system of a country and the fact that "the national accounting traditions tend to continue" (Nobes, 2006, p. 235). The implementation of IFRS is considered expensive, complex and cumbersome (Callao, et. al., 2007, p. 159). The obstacles identified were: the complex nature of the standards, the lack of the instructions for the application, the close link between financial reporting and taxation, the inconsistent interpretation, the permanent changes of IFRSs, a poor knowledge of them, the need to change the mentality of the financial department staff (Larson and Street, 2004, p. 112).

A big number of papers analyze the effects of IFRS adoption examining samples from one country. We present some conclusion of the studies related to Germany, France, Belgium, Spain, UK and Australia.

Between 1998 and 2005 firms in **Germany** could *voluntarily adopt IFRS*. (Bartov et al., 2005) find that value relevance of US GAAP based earnings is higher than that of IAS based earnings, which, in turn is more value relevant than earnings produced under German GAAP. (Gassen and Sellhorn, 2006) document significant differences in terms of earnings quality: IFRS firms have more persistent, less predictable and more conditionally conservative earnings. They show that IFRS adopters experience a decline in bid-ask spread and that IFRS adopter's stock prices seem to be more volatile. Leuz and Verrecchia (2000) examine German firms that voluntarily adopt IAS or US GAAP and, also find that they have lower bid–ask spreads and higher stock turnover ratios, but the difference between IAS and US GAAP firms is not statistically significant. Consistent with the anterior paper, (Leuz, 2003) finds that differences in spreads, turnover, and IPO underpricing are statistically and economically insignificant. In contrast, (Daske, 2006) finds that voluntary IAS adopters exhibit a higher cost of equity capital than local GAAP firms. (Van Tendeloo and Vanstraelen 2005) find that German IAS firms have more discretionary accruals and a lower correlation between accruals and cash flows.

Due to the IAS Regulation EC No.1606/2002, in 2005 the *compliance with IFRS became mandatory*. This situation enables comparison of firms that voluntarily adopted IFRS before 2005 (firms that perceive net benefits of doing so) and firms that were forced to comply as of 2005 (firms that perceive no net benefits of doing so). (Christensen et al. 2008) suggests that firms that voluntarily adopted prior to 2005 did so because they perceived net benefits of IFRS compliance. The authors find that earnings management decreases and timely loss recognition increases after voluntary IFRS adoption. In contrast, firms that postponed adoption until it became mandatory in 2005 did so because they had no incentive to adopt IFRS. They find no accounting quality improvements for firms that resist IFRS until 2005. Their conclusion is that IFRS per se does not change accounting quality. (Haller et al, 2009) quantify the impact on equity and net income by examining the reconciliations of 103 German companies which had to adopt IFRS for their consolidated financial statements in 2005. Consistent with others researches (Hung and Subramanyam, 2007), they observed a significant increase in stockholders' equity and in net income. The increase in stockholders' equity is primarily due to the adoption of IAS 11, IAS 16, IAS 37, IAS 38 and IFRS 3. Concerning net income, the increase especially results from the adoption of IFRS 3.

In **France**, (Marchal et al., 2007) concludes that the global effect of IFRS adoption on the consolidated financial statements of the French groups quoted on stock exchange is not as important as it could have been considered a priori. These effects are the following: the equity has decreased with 2%, the net financial debt has increase with 16% and the net income has increased with 38%. (Lenormand and Touchais, 2008) find that the international standards have positive financial impacts on earnings and equity. Even if the two standards seem value relevant, the authors show that IFRS bring more information. (Cormier et al., 2009) present three major findings emerging from their analyses. First, managerial incentives influence the decision to strategically elect one or more optional exemptions at the transition date. Second, mandatory equity adjustments are more valued than French generally accepted accounting principles (GAAP) equity, suggesting that the first-time adoption of IFRS by French firms is perceived as a signal of an increase in the quality of their financial statements. Third, the value-relevance of optional IFRS equity adjustments depends on whether they result in the disclosure of new information.

Jermakowicz (2004) analyzes the IFRS adoption process in **Belgium**. A survey sent to the BEL-20 companies indicates that implementing IFRS will dramatically change the way these companies design and handle both their internal and external reporting activities, and will increase the comparability of consolidated accounts as well as levels of transparency for many companies. The study concludes that adjustments to translate Belgian GAAP to IFRS resulted in a significant impact on the companies' reported equity, as well as net income.

In **Spain**, (Perramon and Amat, 2007) demonstrate that the introduction of IFRS may influence the profit as a results of the application of fair-value for derivative instruments and new rules for accounting for goodwill. The empirical test reveals that the adoption of IFRS in Spain has a diverse effect on the net profit, which makes it difficult to predict its impact on the other listed Spanish companies. The study of (Callao et al., 2007) indicate that the image of listed Spanish firms differs significantly when IFRS rather SAS are applied in the preparation of financial information. In the balance sheet, this effect is most significant in debtors, cash and cash equivalents, equity, long-term and total liabilities.

In **United Kingdom**, Christensen et al. (2007) have examined the economic consequences for UK firms of the European Union's decision to impose mandatory IFRS. They show that there are cross-sectional variations in both short-run market reactions and long-run changes in cost of equity associated with the decision, suggesting

that mandatory IFRS adoption does not benefit all firms in a uniform way but results in winners and losers. The study of (Iatridis, 2010) indicates that the implementation of IFRSs generally reinforces accounting quality. The findings show that the implementation of IFRSs reduces the scope for earnings management, is related to more timely loss recognition and leads to more value relevant accounting measures. (Paananen and Parmar, 2008) show that despite the fact that US GAAP, IFRS, and UK GAAP are all market oriented sets of accounting standards, both FASB and IASB are more inclined to require fair value accounting with regards to assets and liabilities compared to UK GAAP, which tend to a greater extent to encourage the stewardship approach.

(Goodwin et al., 2008) examine the effect of **Australian** equivalents to International Financial Reporting Standards (IFRS) on the accounts and accounting quality and find that IFRS increases total liabilities, decreases equity and more firms have earnings decreases than increases. IFRS earnings and equity are not more value relevant than AGAAP earnings and equity and while adjustments for changes in accounting for provisions and intangibles other than goodwill are value relevant, they weaken associations with market value. Goodwill adjustments improve associations with market value. (Chalmers et al., 2011) conclude that after the IFRS adoption, earnings become more value-relevant whereas the book value of equity does not. Consistent with an increase in the value relevance of earnings, earnings also become more persistent around IFRS adoption. Their study suggests that even for a country categorized by strong investor protection and high-quality financial reporting and enforcement, IFRS adoption affects the associations between accounting information and market value.

Instead of conclusions

In sum, the literature documents various economic consequences around voluntary or mandatory IFRS adoptions and, in many cases, firms reporting under IFRS appear to enjoy substantial benefits. The IFRS have an Anglo-Saxon origin and related studies find that the adoption of IFRS has had a greater impact on the financial statements of Code versus Common Law countries. Also, for Code Law countries, IFRS increases equity and earnings. The results for the Common Law countries suggest that adoption only modestly impacted the value relevance of equity or earnings.

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