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Adoption of International Financial Reporting Standards (IFRS) and Quality of Accounting Information: A Review of Evidence

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ABSTRACT

The purpose of this review is to provide evidence on whether the adoption of IFRS by countries which had their own accounting standards has had any effect on quality of accounting information thereafter. This review argues that much as IFRS adoption could have a significant effect on financial reporting in relation to reported accounting information and numbers, IFRS application alone, is not sufficient to reduce on the opportunistic behavior of managers. Hence, effective enforcement of IFRS standards by strong institutional framework and monitoring and supervisory systems is necessary to reduce opportunistic behavior of managers. Therefore combination of high quality standards like IFRS and effective corporate governance systems is necessary to enhance the quality of accounting information.

Keywords: *IFRS adoption, Quality of Accounting Information*

1. INTRODUCTION

This paper presents a review of the recent literature for studies linking the application of International Financial Reporting Standards (IFRS) with the quality of accounting information. The discussion is centered on the argument, whether the application of IFRS is sufficient to reduce information asymmetry and hence improve the quality of accounting information. International convergence and application of financial reporting standards in the financial reporting process is viewed by accounting practioners as one of the key determinants of the quality of financial information.

The worldwide use of IFRS accounting standards either on compulsory or on permitted basis has gained a lot of attention and acceptability around the world (Gannon and Ashawal, 2004; Stenka and Ormrod, 2007). In 2002, the European Union (EU) parliament passed regulation[1] mandating the official adoption of IFRS in the EU starting 1st January 2005. This regulation required all listed companies in the European Union (EU) with debt or equity securities to comply with the use of the International financial reporting standards (IFRS[2]) in the preparation and presentation of their financial statements[3] (Stenka and Ormrod, 2007).

The EU regulation mandating the official adoption of IFRS marked the commencement of significant reforms in accounting regulation and capital markets in the European Union. And for a country like the United Kingdom with domestic regulation on accounting practice (SSAPS and later FRS), the requirement to converge with IFRS involved a change in the generally accepted accounting principles (GAAP), which likely has significant impact on financial reporting practices with a potential for future economic consequences (Larson and Street, 2004; Ormrod and Taylor, 2004; Beattie et al, 2006 and Stenka and Ormrod, 2007). These impacts relate to capital market liquidity, capital market equity valuation and the reaction of the capital market to the financial accounting information like accounting earnings, and book values.

For example, Paananen and Parmar, (2008) show that the previous United Kingdom GAAP was inclined to focus more on operating performance of the firm than on the financial position of the firm. Perhaps suggesting that, the United Kingdom GAAP had a tendency to focus more on the investors need for information on the manager's stewardship like earnings compared to information on firm valuation like book values[4].

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[1] On 19th July 2002, the European Parliament passed a regulation of "The European Union Act 1606/2002-the Application of International Accounting Standards"

[2] In this study IFRSs will be taken to include both international financial reporting standards issued by IASB, and the International accounting standards previously issued by the IASC.

[3] It is worth noting that before the introduction of IFRS in the EU, accounting standards were responsibility of each member state. The EU provided the framework, but within the framework each country had its own rules, usually drawn up by national standards setters (Sampers, 2008). Therefore, the adoption of IFRS in the EU means the harmonisation of accounting standards and should lead to achievement of the following objectives as outlined in the preamble to the regulation

- Transition to a single set of international standards for high quality financial statements
- Sufficient guarantees for a high degree of transparency and comparability of financial statements, and
- Creation of a level playing field for European companies on both the European and Global financial markets.

[4] Comparison of some of the UK standards related to IFRS standards shows significant differences in measurement and recognition of financial information between the UK standards and IFRS; for example,

- Under the UK GAAP SSAP 9(Stocks and long term contracts), a company can adopt the LIFO method in evaluation of inventory. Under IFRS, IAS 2(Inventory valuation) LIFO is not permitted. The LIFO method over states inventory and therefore under states the reported profits of the firm. The critics of LIFO method of inventory valuation attribute to understatement of reported earnings for the period;

Weetman, et al (1998) and Penman (2007), show that IFRS standards are of high quality accounting standards[5] compared to accounting standards issued by individual countries in the EU such as the UK standards. The high quality of IFRS accounting standards is also associated with their orientation to fair value valuation and a focus on balance sheet information.

The adoption of the IFRS by EU countries was expected to lead to realization of quality financial information contained in the financial reports. After the adoption of IFRS Financial reports should be able to portray more reliable, relevant and comparable accounting information, making companies that report using IFRS to have high competitive position in the capital markets (Samper, 2008) in Europe and other markets in the world.

Raffournier (2008) argues that IFRS adoption is expected to lead to the following consequences. Information asymmetry should decrease, because IFRS are more market oriented and the IFRS disclosure requirements are larger compared to the United Kingdom GAAP. Earnings management should decrease, because IFRS are more precise, IFRS admit a limited number of options and hidden reserves are prohibited. Accounting data should be more value relevant because IFRS are more market oriented, earnings management is difficult under IFRS and IFRS make larger use of fair value accounting. Lastly, IFRS adoption should lead to decrease in cost of capital

2. IFRS ADOPTION AND INFORMATION ASYMMETRY

Many studies have examined the effects of the mandatory adoption of IFRS and financial reporting in the EU in general. However, some other studies have specifically examined the question whether IFRS adoption and application in financial reporting has had any significant effect on information asymmetry.

- The UK FRS 10(Good will and Intangible Assets) requires an entity to amortise goodwill over its expected useful life, if that useful life is less than twenty years. The "Impairment" review is only allowed at the end of initial year of recognition of the intangible asset, where the entity states that the goodwill is deemed to be longer than twenty years. IFRS provisions in IAS 38(Intangible assets), intangible assets amortizations are prohibited and the directors must undertake an impairment review on an annual basis; and
- The UK FRS 18(Accounting policies), management must review accounting policies only to ensure they remain the most appropriate to its particular circumstances' for purposes of giving true and fair view. IFRS provisions, IAS 8(accounting Policies) a company can only change its accounting policies if it results in the financial statements giving more 'relevant and reliable' information.

[5] Nobes and Parker(2004) discuss in details the comparative international accounting

Information asymmetry increases opportunity for manager's discretionary accounting choices, leads to agency conflict and thus affects the integrity of the financial reporting process of a firm and the quality of accounting information therein financial reports will come to question. Decrease in information asymmetry reduces agency conflict, reduces the manager's opportunistic behavior and enhances the reliability of financial information in financial reports. Reliable financial accounting statements information provides investors with an opportunity to make informed decisions and rational choices on their investments.

Raffournier, (2008) suggests that IFRS adoption leads to reduction in information asymmetry in financial accounting information in financial statements provided by managers. He argues that, this is because IFRS are market oriented and the disclosure requirements are large. In addition, IFRS accounting choices are specific; the manager's application of specific accounting treatments is enhanced and is enforceable.

Similarly, Leuz and Verrecchia (2000)[6] find that firms that adopt international GAAP such as IFRS decrease the bid ask spread and increase the trading volume which they interpreted to imply decrease in information asymmetry. In addition, Platikanova and Nobes (2006) argue that, on average, the bid ask spread declined after the IFRS adoption in most countries. However, Dumontier and Maghraoui (2006) suggest the effect of IFRS adoption on information asymmetry is limited to small firms. In large firms the effect of IFRS adoption may not be significant.

3. IFRS ADOPTION AND EARNINGS MANAGEMENT

One of the concerns by scholars of earnings management is whether the adoption of IFRSs also means that earnings management should decrease and hence the quality of earnings reflected in accounting reports is increased. Therefore the violation of IFRS in financial reporting by managers may be difficult compared to the less precise standards such as the United Kingdom standards. IFRS also admit a limited number of options in recognition and measurement of accounting transactions in financial reporting and hidden reserves are prohibited (Raffournier, 2008). The perceived high quality features of IFRS should make opportunistic earnings management difficult.

Secondly, there is an argument that, the adoption of common set of accounting standards like IFRS, across countries, improves earnings reliability through the ease of monitoring and comparison of financial reports, which puts

[6] Leuz and Verrencia (2000) used German data to examine the effect of IFRS and US GAAP adoption on the information asymmetry. They used the effect of bid ask spread, the trading volume and the volatility of returns as measures of information asymmetry.

pressure on management to report faithfully and truthfully and engage in less earnings management activities (Soderstrom and Sun,2007). Similarly Ewert and Wagenholfer (2005) argue that strengthening of accounting standards (which the adoption of IFRS is aimed at) reduces earnings management and improves earnings quality and reliability.

Cai, Rahman and Courtenay (2008) study the effect of IFRS adoption and its enforcement on earnings management. They find that earnings management in IFRS adoption countries has been decreasing in recent years. Their findings show that countries with stronger accounting standards enforcement[7] generally have less earnings management.

Christensen et al (2007) examine the difference in the quality of reported accounting information between firms that do not resist[8] adoption of IFRS and resisters[9] of adoption of IFRS. They find that voluntary adopters of IFRS exhibit less earnings management and more timely loss recognition subsequent to the adoption of IFRS. However, they find no change in quality of reported accounting information among resisters, which they attributed to the resisters less dependence on equity market financing; therefore they do have the motivation to report reliable accounting information.

Barth et al (2008) compare earnings management for 21 countries, for firms that voluntarily switch to IFRS with firms that use domestic accounting standards. They find that after the adoption of IFRS, firms have higher variance in changes in net income, a higher ratio of variance changes in net income to variance of changes in cash flows, low frequency of small positive net income and higher frequency of reported large losses. Barth et al (2007) interpreted their findings to imply that firms applying IFRS evidence less earnings management.

Using a sample of the publically listed companies of 15 EU member countries for the years 2000 to 2007, Tang et al (2009) find some evidence of accounting quality[10] improvement after IFRS adoption. They argue that, there is less of opportunistic earnings management with evidence of smaller magnitude of absolute discretionary accruals, and higher accruals quality after IFRS adoption.

In contrast, Van Tendelloo and Vanstreaelen (2005) and Goncharov and Zimmerman (2006) using evidence from Germany, examine the prevalence of earnings management before and after the adoption of IFRS. Both studies find that IFRS firms have more discretionary accruals and a lower correlation between accruals and cash flows. These results show that companies that adopt IFRS do not present different earnings management behavior compared to companies reporting under the German GAAP.IFRS adoption therefore does not necessarily bring a change in earnings management behavior.

Similarly Paananen (2008) examined whether accounting quality increased after compulsory IFRS adoption using Swedish publically listed firms from 2003 to 2006. Using earnings smoothing as proxy for earnings management, Paananen (2008) documents evidence that shows that IFRS adoption does not reduce income smoothing.

Tang et al (2009) also shows that firms engage in more earnings smoothing and less timely recognition of large losses after the IFRS adoption. Tang et al (2009) argue that, given that earnings smoothing and timely recognition of looses are the main ways of earnings management, it therefore means that IFRS adoption may limit managements opportunistic discretions by reducing available accounting treatment alternatives but does not entirely eliminate earnings management incentives.

In a related study, to that of Paananem (2008), Lin and Paananem (2008) using a sample of German firms after the adoption of IFRS, examine changes in patterns of earnings management activities over time. They find that earnings management is higher in the post IFRS adoption period. They argue that adoption of IFRS itself may not improve accounting quality and that IASB[11] has not been effective in decreasing earnings management activities.

4. IFRS ADOPTION AND VALUE RELEVANCE OF ACCOUNTING EARNINGS

The adoption of IFRS is expected to have an effect on how the financial markets interpret accounting information. IFRS adoption should lead to positive improvements of the value relevance of accounting data opposed to domestic standards of the individual European countries. The value relevance of accounting data implies the ability of accounting data to reflect contemporaneously market prices or market returns (Raffournier, 2008).

[7] Enforcement is defined by European Federation of Accountants' (FEE) as 'a system to whenever possible prevent, and hereafter identify and correct, material errors or omissions in the application of IFRS in financial information and other regulatory statements issued to the public,' (FEE, 2002, 31). The Committee of European Securities Regulators (CESR) defines enforcement as the combination of supervision and sanctioning in cases of non compliance with the rules.

[8] Firms that voluntarily adopted IFRS

[9] Firms that adopted IFRS when it became mandatory in 2005

[10] In this study the magnitude of discretionary accruals is used as a measure of accounting quality

[11] IASB- International Accounting Standards Board is the body responsible for issuing of IFRS

Hung and Subramanyam (2007) compare the value relevance of IFRS based accounting data and the accounting data reported based on the German GAAP by regressing stock prices on book values of equity and net income. They find that the book values of equity have higher coefficients under IFRS and net incomes have higher coefficients under the German GAAP. Hung and Subramanyam (2007) interpret their findings to mean that IFRS adoption has no significant effect on the value relevance of accounting book values and net income. If IFRS had significant effect, then the market pricing of equity should significantly depend on net incomes.

Similarly a study by Paananen (2008) documents evidence that suggests that the value relevance of accounting figures is not affected by IFRS adoption. Paananen (2008) findings is supported by evidence from the study of Lin and Paananen (2008) that suggests that the value relevance of equity and earnings decreased after the IFRS adoption.

Recent study by Paananen and Parmar (2008) using UK sample, find that investors rely less on earnings information after the adoption of IFRS. According to Paananem and Parmar (2008) findings, investors do not find earnings value relevant in increasing the ability of accounting information to predict future equity values that imply a return to the investors.

However, Raffournior (2008) argues that IFRS based earnings should be more value relevant; because IFRS are more market oriented and that IFRS make large use of fair value accounting making the financial accounting information relevant and reliable. Therefore investors can depend on the financial statements made based on IFRS to make informed economic decisions.

Similarly Gassen and Sellhorn (2006) in their study on the adoption of IFRS, by comparing firms that adopted IFRS voluntarily and those that did not, find that firms that voluntarily adopted the use of IFRS in financial reporting have persistent, less predictable and more conditionally conservative earnings compared to those firms that used the German GAAP.

Bartov et al (2005) study on value relevance of accounting earnings, finds a higher coefficient on IFRS based reported earnings than the German GAAP reported earnings. Bartov et al (2005) findings imply that the value relevance of accounting earnings reported based on the IFRS is higher than the value relevance of accounting earnings reported based on the German GAAP, suggesting that investors attach significant importance to IFRS reported earnings

The study of Barth et al (2008) documents evidence that shows greater value relevance of earnings for firms that voluntarily switched from German domestic accounting standards to IFRS. Barth et al (2008) argue that since the adoption of IFRS in Germany, firms have exhibited more value relevant accounting figures compared to the use of the German GAAP. Similarly Jermakowicz et al (2007) document evidence that shows that the value relevance of accounting earnings is higher for DAX-30 companies using IFRS or the US GAAP compared to companies using the Germany GAAP.

Platikona and Nobes (2006) investigate the effect of the IFRS adoption in a market liquidity study using a sample from 15 EU countries between 2003 and 2005. They find that the informativeness of financial reporting increased after the adoption of IFRS.

Horton and Serafeim (2006) investigate the difference between UK GAAP and IFRS using the UK firms only. They used the reconciliation between UK GAAP and IFRS at the time of the adoption in an event study. They find that the market reaction to negative reconciliation adjustments of earnings produces a negative reconciliation adjustment of earnings produces a negative abnormal return and positive trading activity.

Horton and Serafeim (2006) argue that positive earnings adjustments are value relevant before disclosure while negative earnings are value relevant only after disclosure. Moreover they find that IFRS based adjustments related to impairment of goodwill, share based payments, employee benefits, financial instruments and deferred taxes are incrementally value relevant.

Daske et al (2007) in their study into the capital markets responses to the mandatory adoption of IFRS have established that there is significant improvement in market liquidity and increases in the market equity valuation after the adoption of IFRS. Suggesting that, the adoption of IFRS has led to improvement in the quality of financial reporting, and a positive assessment of accounting information by the investors.

However Daske et al (2007) also argues that there are considerable differences in IFRS adoption in countries and the benefits of IFRS adoption can be realized only in countries that have system of strictly enforcing high quality financial reporting incentives.

Cai, Rahman and Courtenay (2008), argue that what is most crucial on top of adoption of IFRS is their enforcement. Because enforcement mechanisms vary across countries, adequate and uniform application of IFRS may be relatively difficult to achieve across board and this is complicated by the presence of institutional differences. They suggest that besides accounting standards other factors should be integrated in financial reporting to have desired impact on financial accounting reporting quality.

5. CONCLUSION

IFRS like any other standards allows financial accounting information providers considerable freedom of choice, and the application of the standards requires estimates and choices from management. Therefore, IFRS can also provide management with an opportunity of choice to apply the standards in such a way as to strictly comply with the rules, that is, to adopt, minimal approach. Management can also choose an approach resulting in the most informative form of financial reporting for their company, in this case the markets response is expected to be positive (Sampers,2008[12]).

Sampers (2008) also argues that whether or not companies opt for the most informative form of financial reporting depends on other factors like, the legal environment in which they operate, the functioning of the capital market and the company specific characteristics like the structure of corporate governance. Therefore, the change over to IFRS as high quality standards cannot achieve positive market response alone but a combination of factors.

Sampers (2008) arguments and the findings of Daske et al (2007) are similar to the findings of Soderstrom and Sun (2007) that have shown that, the corporate governance supervisory frame work and the presence of reporting incentives influence the quality of financial reporting. Similarly Tang et al, (2009) documents evidence that is consistent with the notion that if firms have strong earnings management incentives, changing accounting standards alone may not enhance accounting reporting quality.

Wang and Yu (2008) suggest that better accounting standards are helpful only in countries with proper reporting incentives such as effective shareholder protection, effective legal environment and developed stock market. Moreover Kim and Shi (2007) argue that the cost of equity reducing effect of IFRS adoption is greater when IFRS adopters are from countries with weak institutional infrastructure.

Thus, the extant Literature on IFRS adoption shows that the evidence of the effect of IFRS adoption on accounting information is mixed. This can be attributable to the following reasons. Most of the studies so far have tended to compare post IFRS adoption period to pre adoption period based on voluntary adoption of IFRS. The criticism to these kinds of studies is related to the differences in enforcement of application of IFRS among countries and the motivating factors and incentives of IFRS adoption. Moreover companies have different levels of supervisory framework and implementation; the enforcement of the IFRS standards may be at different stages for companies in one country.

The second stream of IFRS adoption studies focus on firms that have voluntarily adopted IFRS with non IFRS adopters. Most of these studies present methodological problems that relate to the sample design and time frame of the study. Most of these studies have sample periods 1996 to 2006 inclusive. The period before 2005, defined the time when a lot of work to improve comparability of financial statements and reduce the number of accounting treatments was on going in the EU. The effectiveness of this process most probably has effect on the findings of these studies

The third stream of IFRS studies is that draws a combined sample of IFRS adoption from EU countries. The results from this variant may not be generalized because of homogenous problems. Before the adoption of IFRS in EU, each EU country was at the different levels of financial reporting quality (practice) since each had its own standards. More over there is considerable variation in the level of IFRS compliance among European countries. The reason is significant differences in legal and institutional frame work among the EU countries has an effect on the level of adoption of IFRS and the subsequent accounting information in financial reports produced using IFRS.

From the review of current literature on IFRS adoption, it is also evident that most of the studies are mainly based on the sample data from continental Europe countries, for example, Germany and Sweden. So far little evidence has been documented on the IFRS adoption and its effect on accounting information and its relation to value relevance in a setting like UK and the US, with well developed financial markets and market oriented corporate governance code in the name of revised combined code.

This study argues that much as IFRS adoption could have significant effect on financial reporting in the UK in relation to the reported accounting information and numbers, IFRS adoption alone is not enough to reduce on the opportunistic behavior of managers. Adopting high quality standards like IFRS might be a necessary condition for high quality information but not a sufficient one (Ball et al., 2003).

Effective enforcement of IFRS standards by strong institutional framework and a monitoring and supervisory system is necessary to reduce opportunistic behavior of managers. Therefore a combination of high quality standards like IFRS and effective corporate governance systems is necessary.

Finally, this study proposes the adoption of IFRS significantly improves the financial reporting process, and leads to production of more reliable accounting information

[12] Peter Sampers (2008) delivered an Interim Report on the introduction of international financial reporting standards in the European Union, in acceptance of position of Professor of Financial Accounting at Maastricht University.

(earnings). Therefore a combination of IFRS standards and effective corporate governance improves the financial reporting process further. Hence the value relevance of accounting information (earnings) produced under IFRS and effective corporate governance should be well enhanced.

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