# Voluntary and mandatory adoption of IFRS: a synthesis and a literature review

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## 1. Introduction

Along recent decades International Financial Reporting Standards (IFRS)[1] have been increasingly adopted at the global level as the preferable reporting system to document corporate transactions instead of previously applied domestic accounting standards. The foremost underlying explanation for this radical expansion is, most likely, the globalization of business and the gradual economic integration of financial markets. Globalization and economic integration take several forms, each one demanding an internationally accepted set of accounting concepts and common valuation rules to be implemented by reporting entities:

1. The great expansion of multinational enterprises and conglomerates. Multinational corporations, most often through mergers and acquisitions, as well as the establishment of new local branches and coalitions with domestic firms, make transactions in multiple countries and regions with different accounting standards and national financial reporting rules. The necessity of a common accounting language that would facilitate reporting of consolidated statements and satisfy the various information needs of diverse stakeholders (e.g., investors, customers, suppliers) has frequently raised IFRS as an advantageous solution.

2. Cross-listing. The pursuit of external funds and increased liquidity leads several firms domiciled around the world to cross-list and trade their equity shares in large international equity markets. Equity markets that allow foreign registrants usually require them to prepare their financial statements in accordance with either the local accounting standards of the country in which the stock exchange operates through a reconciliation procedure (e.g., U.S. equity markets) or more frequently with IFRS[2]

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[1] Till 2001 international standards issued by the IASB's predecessor (IASC) were described as International Accounting Standards (IAS). We use the terms IFRS and IAS interchangeably depending on the time period or the study we refer to.

[2] For instance, the Stock Exchange Automated Quotations (SEAQ) International Equity Market of London (the largest international equity market) requires foreign registrants to report under IFRS or U.S. GAAP. Another example is the stock exchange of Hong Kong which accepts financial statements prepared under IFRS as satisfying its listing requirements. It is also notable that U.S. Securities and Exchange Commission (SEC) is considering to allow foreign firms to prepare their SEC filings under IAS without reconciling to U.S. GAAP (Ashbaugh and Olsson, 2002).

with the premise that IFRS is a set of high quality accounting standards that ensures a high level of transparency.

3. The development of stock exchanges. In an attempt to foster investors' confidence, enhance the market capitalization of their stock exchanges and achieve economic growth, several countries with emerging financial markets have adopted IFRS as the set of accounting standards that listed and/or unlisted firms should follow in their reporting process. Brazil and China are representative examples of countries that implemented IFRS to bring their reporting practices in line with international trends in an effort to attract foreign investments[3]. An additional reason for which IFRS have occasionally been adopted is the preference of several local governments to allocate their financial resources for improving other aspects of their financial reporting system that would facilitate the functionality of their stock market. In those cases, IFRS constitute an already developed set of high quality accounting standards, allowing local governments to save resources instead of spending them to form their own domestic accounting standards[4]. In the stock exchanges' development process the mergers of several stock exchanges that have taken place in the recent decades should also be included. For instance, in 2000, Paris Bourse, Brussels Stock Exchange and Amsterdam Stock Exchange were merged in a single one stock exchange, the Euronext. These actions reasonably highlight the importance of a common set of accounting standards such as IFRS.

4. The required uniformity in the borders of the European Union (EU). The establishment of the EU was actually a result of the growing movement of people, goods, services and capital across the European countries and their progressive integration. To facilitate the convergence of economic transactions and ensure their transparency, the EU has been striving for a long time, to achieve accounting harmonization through EU directives in the past, and, more recently, the European Commission Regulation 1606/2002 which requires the mandatory enforcement of IFRS for consolidated statements of European listed firms since 2005[5]. The compulsory adoption of IFRS by the European Union members is one of the most tremendous events in the accounting history, as for first time so many different nations and jurisdictions are required to implement a single one set of accounting standards. This action has created a nascent academic and political interest on the effectiveness of enforcing IFRS at an international level.

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[3] Indeed, several countries endorse IFRS but also retain local peculiarities pertained in their former national standards. For example, due to delays in translating IFRS in Turkish, domestic listed firms do not fully comply with IFRS (see www.iasplus.com).

[4] For instance, the standard setting body of Kenya preferred to adopt IFRS instead of developing national accounting standards in order to reallocate its funds to strengthen activities aimed at the effective implementation of accounting and auditing standards.

[5] From a legislative standpoint, though, a directive is quite different to a regulation. The process of implementing a directive requires further legislative actions by member states to introduce it in their national legislation. This gives great latitude to the member-states concerning the proper compliance with it. In sharp contrast, a regulation is compulsory and no additional actions are required by member-states in order to bring it into effect (Alexander et al., 2007).

## 2. The importance of empirical evidence on IFRS effects

As stated above, since 2005, all listed firms domiciled in the European Union are required to prepare their consolidated statements in accordance with IFRS (EC1606/2002) while IFRS proponents and boosters argue that the mandatory enactment should be also expanded to the unlisted enterprises in the near future[6]. Additionally, on a worldwide scope, more and more firms as well as countries voluntarily adopt IFRS as their core set of accounting standards while FASB and IASB are committed to a convergence project that aims at developing a single set of high quality accounting standards[7]. Empirical examination of countries and firms that have already adopted IFRS is, therefore, valuable, as it provides direct evidence about the effectiveness of IFRS as a tool to achieve expected benefits in the future. From a theoretical and practical standpoint, such evidence deepens our understanding about the importance of accounting standards in the financial reporting system, the proper enforcement of new accounting rules, leading factors of successful implementation, accounting areas that need to be further developed and important directions for future actions.

Arguably, there are two main considerations about the efficacy of IFRS as tool of improving international accounting reporting. First, are IFRS more optimal than the previously applied sets of standards? The answer to this question is not straightforward. It is widely accepted that despite their accounting quality, in an attempt to be applicable by a wide range of potential users IFRS, do allow several options on reporting specific accounting transactions. This may give greater latitude for income manipulation actions in countries where managers have a propensity to earnings management. In addition, IFRS are clearly investor-oriented (Barth et al., 2008) and are imbued with a fair value philosophy (Ball, 2005) contrary to national standards in several code-law countries which are creditor-oriented and promote historical cost. Thus, the optimality of IFRS in those cases is still debatable, although due to the unceasing process of globalization the relevance of this point hugely reduces.

Second, and more important, is the enforcement of a high quality accounting standards set enough to assure material improvements in the financial reporting system? In the case of voluntary adoption results are mixed whereas in the case of mandatory adoption initial empirical evidence suggests that expectations are borne out only under very specific circumstances. These criticisms emanate mainly from the recently emerging literature of reporting incentives. Particularly, the "incentives

[6] Indeed, the recent IASB's accomplishment of IFRS for Small and Medium Sized Entities suggests that their enforcement in the European Union is just a matter of time.

[7] There is also in progress a similar, although less urgent, convergence project with Japan. In December 2009 the Japanese Financial Services Agency (FSA) permitted certain qualifying domestic companies to apply IFRS for fiscal years ending on or after 31 March 2010 while the IASB and the Accounting Standards Board of Japan (ASBJ) are working to address the outstanding issues by 2011. Mandatory enforcement of IFRS for listed companies is expected around 2012 (www.iasb.com).

literature" suggests that preparers' (managers' and auditors') reporting incentives dominate accounting standards and ultimately determine the quality of accounting information (e.g., Ball et al. 2000; Ball et al., 2003). The direct implication is that in countries that reporting incentives are of low quality due to inadequate economic infrastructures (e.g., weak legal enforcement, low quality of accounting profession, poor shareholders' protection, infeasible corporate governance mechanisms) simply mandating IFRS would have minor effects. Apparently, this argument also applies to firms and countries which claim that have voluntarily adopted IFRS but do not rigorously comply with them[8]. With those considerations in mind, next section reviews the relevant empirical literature concerning IFRS adoption.

## 3. Evidence on voluntary adoption of IFRS

This section reviews the empirical studies related to voluntary adoption of IFRS around the world. The term voluntary refers to a firm that adopts IFRS as its core standard set although it is not compulsory by its national legislative rules. At a country-level, however, things are more complicated. Particularly, in a case that a country voluntarily implements IFRS as its national accounting standard set and afterwards obliges indigenous firms to follow them, it is still considered as voluntary adoption at the country-level but mandatory adoption at the firm-level. While the decision of the national standard setters to adopt IFRS probably derives from local market and political needs instead of disciplining to international regulation, firms were still required to report under the new accounting rules[9].

### 3.1. Leading incentives for IFRS adoption

The first stream of studies mostly explores the underlying incentives that lead firms and/or countries to voluntary IFRS adoption. In most cases, the evidence reported is much in line with accounting and economic theory analyzed previously. For instance, at the firm-level the degree of international operations that a firm conducts, cross-listing in multiple stock exchanges and frequent equity issuing are major motivations of voluntary IFRS adoption (Dumontier and Raffournier, 1998; El-Gazzar et al., 1999; Ashbaugh, 2001; Cuijpers and Buijink, 2005; Gassen and Sellhorn, 2006). In a similar vein, international exposure in the form of diffused ownership and domiciling in regions that are members of world or regional treaties (such as the EU) profoundly induce firms to implement IFRS as their core set of standards (Dumontier and Raffournier, 1998; El-Gazzar et al., 1999; Gassen and Sellhorn, 2006). Finally, there is evidence that firms domiciled in countries characterized by weak shareholder protection and inadequate governance mechanisms tend to adopt IFRS to improve -or

[8] For example, Street and Gray (2002) find severe non-compliance in the annual reports of voluntary adopters.
[9] Apparently, the validity of this assumption is still questionable.

to signal that they have improved- their financial reporting system (Cuijpers and Buijink, 2005).

At the country level, empirical evidence is unfortunately sparse. Nevertheless, it seems that countries with relatively weak investors' protection mechanisms in place and a commitment to opening up their capital markets are more likely to endorse IFRS (Hope et al., 2006). Indeed, the trend of IAS adoption is more pronounced in developing countries with emerging capital markets which utilize IFRS as a vehicle to upgrade their economic infrastructures, attract new investors and encourage their confidence[10]. In these cases, high literacy race and influences of the Anglo-American culture have been found to raise the possibility of IFRS adoption (Zeghal and Mhedhbi, 2006).

3.2. Effects of IFRS voluntary adoption

The second stream of studies related to voluntary IFRS adoption is mostly concerned with the effects of this switch. To conclude whether IFRS adoption was actually beneficial all studies employ various metrics of accounting quality. The term accounting quality may either refer to capital market effects (e.g., reduction in information asymmetry and the required cost of capital, increase in the value relevance of financial disclosures) or to improvements in variables that measure the ability of financial statements to reflect firms' underlying economics (e.g., earnings smoothing, earnings management, timely loss recognition)[11]. Occasionally, some of these studies take into account firms' incentives to adopt IFRS in an effort to control for self-selection bias[12] (e.g., Leuz and Verrecchia, 2000; Hung and Subramanyan, 2007).

Concerning first information asymmetry and cost of capital, country-specific empirical results indicate that IFRS adoption significantly declines the information gap between insiders and outsiders of a firm compared to national accounting rules and alleviates adverse selection problems (Leuz and Verechia, 2000; Gassen and Sellhorn, 2006). However, empirical evidence derived from studies with multinational samples provides less robust results that IFRS efficiently reduce information asymmetry and the cost of capital (Cuijpers and Buijink, 2005; Daske et al., 2007). According to Daske et al. (2007) the mixed evidence could be ascribed to severe heterogeneity in IFRS compliance among firms. However, even when they partition their sample into "serious" and "label" adopters they find weak only support that the formers realize less information asymmetry and reduced cost of capital.

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[10] See www.iasplus.com

[11] For a thorough review of accounting quality literature see Dechow et al., 2009.

[12] Self-selection bias incurs, for example, when firms that exhibit certain characteristics, which lead to less information asymmetry than other firms, also tend to adopt IFRS. This would overestimate the significance of IFRS in a model that examines the effects of IFRS choice on information asymmetry. Self-selection bias is a serious concern in the voluntary IFRS literature which casts doubt about the empirical results relating to the importance of the standards choice.

In a similar vein, several studies that investigate IFRS effects in earnings management, value relevance and conditional conservatism find mixed and often contradicted results according to the sample used, the methodology and the quality metrics employed. Thus, Bartov et al. (2005) find that German firms which adopted IAS provide more value relevant earnings, in contrast to Hung & Subramanyam (2007) who also investigate German firms but claim that value relevance and conditional conservatism did not incur significant improvements after IAS adoption. In addition, Eccher and Healy (2000) find that IAS standards do not provide material benefits concerning predictions of future cash flows and value relevance in sample of Chinese firms. On the other hand, Barth et al. (2008) using a multinational sample of firms find significant evidence that voluntary IAS adopters experience less earnings management, more timely loss recognition and more value relevant earnings than non-adopters. However, they mention that these results can not be definitely attributed to the change in financial reporting system rather than to changes in firms' incentives and the economic environment. Supportive results are also provided by Ashbaugh & Pincus (2000) who report that analysts' forecast accuracy is negatively related to domestic standards' differences with IAS and that it materially improves after IAS adoption.

The mixed inferences conveyed by the aforementioned studies, concerning the benefits associated with IFRS voluntary adoption could be attributed to several factors: first, there is not a specific research design to evaluate the effects of the new standards applied. Empirical studies usually differ in quality metrics, control variables, econometric procedures, datasets and time periods, which leads to a variety of results. Second, IFRS' superiority over previous applied standards is not incontestable. If domestic accounting standards better fulfill the needs of financial statements' users, observing deterioration in the employed metrics would be unsurprising. Third, disentangling the pure effects of IFRS adoption from other improvements in a firm's corporate strategy is not a trivial task. As firms have the option to adopt or not IFRS, the choice to switch may be part of an overall commitment to better reporting behavior. Even worse, IFRS adoption could be just a signal used by firms to inform stakeholders about the enhanced transparency of their disclosures. Studies that explore effects stemming from the mandatory IFRS implementation probably deal better with the last issue.

## 4. Evidence on mandatory adoption of IFRS

Most empirical evidence from mandatory IFRS adoption comes from their recent enforcement in the European Union while some evidence is also available from other countries that voluntarily adopted IFRS in the past and obliged their domestic firms to adhere to. International literature relating to mandatory IFRS implementation is advantageous to our understanding concerning the efficacy of enforcing accounting rules to achieve certain goals. As the decision of a firm to adopt IFRS in the case of

mandatory IFRS application is mostly exogenous, self-selection bias concerns are of less importance than the voluntary IFRS literature. In fact, mandatory IFRS adoption reveals the pure effects of enforcing new accounting rules and contributes to a long standing debate concerning accounting regulation in general and the role of accounting standards per se (see, for example, Watts and Zimmerman, 1986).

In a similar notion to the voluntary-IFRS literature, studies exploring the compulsory IFRS implementation try to observe changes in quality metrics stemming from IFRS reconciliations or the figures reported under the new regime. Turning first to a study that employs metrics which measure capital market benefits, Daske et al. (2008) examine the economic consequences of mandatory IFRS adoption such as changes in market liquidity, cost of capital and Tobin's fee. Using a multinational sample of firms that were mandated to adopt IFRS, they do find evidence of beneficial changes in the above measures but only in jurisdictions where firms have incentives to be diligently transparent and the legal enforcement is ruthless.

The evidence provided by Daske et al. (2008) that beneficial effects are realized only in favorable economic environments and by "serious" adopters, probably explains the disapproving results in studies that measure quality according to the presence of earnings management and the value relevance and conditional conservatism of earnings using country-specific data. For instance, Christensen et al. (2008) examine the impact of incentives on accounting quality changes around IFRS adoption in Germany. They use two samples of IFRS adopters: voluntary adopters (i.e. firms that voluntarily adopted IFRS prior to 2005) and "resisters" (i.e. firms that were forced to adopt IFRS since they became mandatory). They suppose that resisters' reporting incentives are of lower quality than volunteers'. Similar to Barth et al. (2008) they examine two dimensions of accounting quality: earnings management and timely loss recognition. Consistent with their prediction they find that only voluntary adopters exhibit a material improvement in accounting quality.

Several other country-specific studies amplify the notion that IFRS benefits are difficult to observe. Particularly, Schandewitz & Vieru (2008) in Finland, Paanen (2008) in Sweden, Gjerde et al. (2008) in Norway, and, Karampinis & Hevas (2009) in Greece find little evidence supporting the superiority of IFRS over domestic accounting standards concerning earnings management, value relevance and conditional conservatism. In addition, Chen et al. (2009) using a multinational sample of European Union members do find some evidence that IFRS enforcement improved accounting quality indicators such as earnings smoothing, accruals management, the magnitude of discretionary accruals, accruals quality and timely loss recognition, but their results are mixed and lack statistical significance. Finally, Horton et al. (2009) examine the effects of IFRS mandatory reporting in sixteen European countries on analysts' forecast accuracy, disagreement and volatility of revisions. Similarly to Christensen et al. (2008) and Daske et al. (2008), they find that the most significant improvement in the aforementioned measures is enjoyed by firms that had voluntarily

adopted IFRS before the transition date contrary to mandatory adopters which benefit little.

A direct criticism of these studies is that their majority conducts a country-specific research without underpinning theoretically this choice. Thus, extrapolating the results to other countries or drawing general conclusions seems infeasible. However, taken as a whole, they provide useful insights as they illuminate the importance of preparers' incentives to commit to the new standards. Especially Daske et al. (2008) vividly report that enforcing IFRS could be beneficial provided that they are endorsed in a setting that requires strict adherence to the new accounting rules. Stated differently, institutional infrastructures (legal enforcement, investors' protection, auditors' professionalism, etc.) should be robust enough to guarantee IFRS rigorous enactment.

## 5. Summary and Conclusions

This study attempts to provide a coherent review of the literature relating to the incentives of voluntary IFRS adoption and its effects as well as the effects of IFRS mandatory enforcement. In a nutshell, underlying incentives of IFRS voluntary adoption at a country or a firm level comprise the radical expansion of global business and the integration of capital markets which lead countries and firms in an increasing international exposure. To the extent that this internationalization will last in the future, IFRS will be a prominent vehicle to bring financial reporting in line with international advisable practice.

However, empirical evidence on the effects of IFRS voluntary and especially mandatory adoption suggest that firms or countries which implement IFRS occasionally fail to observe material improvements. Despite potential limitations in their research design and the samples used, the empirical studies reviewed here provide a sharp insight: expected benefits are to be realized only by firms that strictly comply with IFRS and countries that their institutional environment ensures rigorous adherence. Considering that international convergence in accounting practice will be of top priority in the imminent future driving IFRS to acceptance by most countries (Smith, 2008), the above inference has two direct implications: first countries that have already enacted IFRS but their economic infrastructures do not allow high quality financial reporting, have to take further steps aiming at their upgrading in order to observe material changes. Second, countries with emerging capital markets that are contemplating endorsing IFRS to attract foreign investments and enhance their trustworthiness should entail them in an overall convergence strategy project which also ensures integrity and high quality of other governmental aspects to achieve virtual international integration. Otherwise, local informational externalities and lack of comparability will probably resist rendering IFRS to be just a meretricious "label" in the future.

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