

The Role of IFRS on Financial Reporting Quality and Global Convergence: A Conceptual Review

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Abstract

This study examines the role of International Financial Reporting Standards on financial reporting quality and the global convergence. The IFRS adoption is already an issue of global relevance across countries of the world due to the quest for uniformity, reliability and comparability of financial statements of companies. The adoption of IFRS in Europe is an example of accounting quality across-borders with different institutional frameworks and enforcement rules. This allows investigating whether, and to what extent accounting regulation per se can affect the quality of financial reporting and leads to convergence in financial reporting. Specifically, the study review how the change in the recognition and measurement of firms operating accrual item, the loan loss provision, affects income smoothing behaviour and timely loss recognition. The study found that the IFRS convergence reduces the scope for earnings management, is related to more timely loss recognition and leads to more value relevant accounting measures. Thus, the study reviews background and guidance on the change in financial reporting quality following extensive IFRS adoption around the world countries. The study found that a difference in accounting quality is related to country's overall infrastructure setting. The study also highlights the importance of investor protection for financial reporting quality and the need for regulators to design mechanisms that limit managers' earnings management practice. The study found from different literatures that the adoption of IFRS leads to higher quality of accounting numbers and improve foreign direct investment across countries.

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INTRODUCTION

Diversity in the preparation of international accounting practice attracts much attention. Such diversity makes it difficult for investors to read foreign financial statements and may affect firms and international capital markets. The International Accounting Standards Committee (IASC), the International Organization of Securities Commissions (IOSCO) as well as the European Union have both devoted considerable effort to the harmonization of accounting practices across countries. There are many claims by investment professionals that accounting differences may impede international capital flows (Raymond & John, 1998).

International accounting literatures provides proofs that accounting quality has economic significance, such as costs of capital (Leuz and Verrecchia, 2000), efficiency of capital allocation (Bushman et al., 2006; Sun & Zhang, 2006) and international capital mobility (Young and Guenther, 2002). The European Union (EU) Parliament passed a regulation that requires all companies listed in the EU to adopt International Financial Reporting Standards (IFRS) for fiscal years starting after 1 January 2005. Widespread adoption of IFRS will result in a fundamental change in the business environment, prior to 2005; companies followed a variety of country-specific Generally Accepted Accounting Principles (GAAP) around the world. ICAEW (2007) studied 200 EU companies and reveal that 198 disclosed full compliance with IFRS and the remaining two disclosed partial compliance. Though, the ICAEW find that the impact of IFRS adoption on companies varies significantly across the countries depending on the initial degree of similarity between NGAAP and IFRS. The report notes that stakeholders envisaged significant comparability benefits, though more in terms of measurement than disclosure. Similarly, such benefits must be set against the costs of adoption in terms of increased cost and complexity (Ismail, Jon & Osman, 2013; Callao, Jarne, & Lainez, 2007). In an attempt to provide an insight into the effects of the transition, this study review literatures on the effects of

adopting IFRS and the global convergence of accounting standards.

Accounting theory argues that financial reporting reduces information asymmetry by disclosing relevant and timely information (e.g. Scout, 2005; Frankel & Li, 2004). As a result, there is substantial disparity in accounting quality and economic efficiency across countries; international accounting standard (IAS) provide remarkable setting to examine the economic effects of financial reporting. The EU's transition to IFRS may provide an insights as firms from different legal and accounting systems adopt a single accounting standard at the same time.

Naomi and Kevin (2007) affirmed that advancement in the financial reporting environment after change to IFRS is conditional on at least two factors. First, advancement is based upon the basis that change to IFRS constitutes change to a GAAP that persuade higher quality financial reporting. For example, Barth et al. (2012) assert that companies adopting IFRS have less earnings management, more timely loss recognition and more value relevance of earnings, all of which had interpreted as evidence of higher accounting quality. Secondly, the accounting system is a complementary component of the country's overall institutional system (Ball, 2006) and is also determined by firms' encouragement for financial reporting. Daske, Hail, Leuz, and Verdi (2008) reveal that economic benefits of IFRS adoption are limited to firms with incentives to be transparent and where legal enforcement is strong. This is consistent with 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. Other factors associated with financial reporting quality include the tax system (Guenther & Young, 2000; Haw et al., 2004), ownership structure (Ball and Shivakumar, 2005; Burgstahler et al., 2006), the political system (Leuz & Oberholzer-Gee, 2006), capital structure (Sun & Zhang 2006) and capital market development (Ali and Hwang, 2000). Therefore, controlling for these institutional and firm-level factors becomes an

important task in the country's financial environment.

The Effect of Changes in Accounting Systems

Historically, legal systems, political and economical differences, created a vast diversity of accounting systems, which makes meaningful comparison of financial reports across countries difficult. Europe is the origin of many legal systems: English, German, French and Scandinavian, and thus, prior to harmonization, there were extremely diverse, country-specific accounting systems. Recognizing this, members of the EU were the first countries to move toward harmonization of accounting standards. In the late 1970s and 1980s, the EU issued several directives to harmonize financial reporting practices to reduce diversity and encourage cross-border investment and listings. Harmonization of Accounting system advanced in the 1990s with the improvement of International Accounting Standards (IAS) (the originator of IFRS), harmonization events in the EU economy (e.g. adoption of a single currency) and political changes. Though IFRS adoption was not mandatory until 2005, in the late 1990s, firms in some European countries were allowed to use IAS as an alternative for domestic accounting standards.

The study in this section, trace the history of IFRS adoption and describe the findings of research that are associated with its different stages. This will reveals a clear picture of historical differences between NGAAP across the countries relative to IFRS, as well as an understanding of the economic consequences of past accounting harmonization. Results from past literature can provide insights about the role of IFRS adoption in bringing quality financial information.

Adoption of IFRS across the Countries

After the official announcement of the mandatory adoption of IFRS in the European Union in 2002, accounting research has examined the process, especially the impact, progress and difficulties it involves. The current paper focuses on studies which examine the effect of the adoption of IFRS on companies across the countries and the inspiring factors of the degree of the adoption. The

effect of IFRS adoption on cross-country studies made-up of: the ones with international focus such as Hodgdon et al. (2009); the ones that focus on regional country groupings such include Macias and Muino (2011) on their study on EU countries; and literatures that focuses at comparative groupings such as Delvaille, Ebbers, and Saccon (2005). Though, cross-country literatures inclined to center on the degree of the adoption; while individual country studies incline to focus on the preparedness of those countries, a more technical discussion of the relative advantages, and an evaluation of the effect on the accounts and on line items are subject of discussion (Ismail, Jon, & Osman, 2013).

Ormrod and Taylor (2004) study the impact of the change from UK-GAAP to IFRS on covenants included in debt contracts. They suggest that the change is likely to result in more volatile reported earnings figures, in addition to differences in reported profits and statement of financial position items. A movement towards cash flow-based covenants might thus be seen as one method of moderating the uncertainty for borrowers arising from the introduction of IFRS.

Brochet, Jagolinzer and Riedl (2012) examine the effect of mandatory IFRS adoption on financial statement comparability. The study isolates the effects of changes in comparability by examining changes in information asymmetry for firms domiciled in UK. UK domestic standards that preceded IFRS adoption are considered very similar to IFRS. The study uses the UK as a setting to isolate changes to the information environment relating to IFRS adoption that more likely to reflect changes in comparability versus information quality. The study reveals that abnormal returns on two proxies for private information (insider purchases and analyst recommendation upgrades) are reduced following the adoption of IFRS. Similar results are obtained for some samples that further isolate the reduction in private information as attributable to increases in comparability: firms having low amounts of reconciling items between UK GAAP and IFRS and firms having ex ante high quality information environments. By combining the results together, it reveals are consistent with

mandatory IFRS adoption leading to enhanced comparability.

Jermakowicz (2004) analyzes the IFRS adoption process in Belgium, similar to Spain, is an example of the continental accounting model. The paper analyzes the impact of IFRS on BEL-20 firms. A survey sent to Belgian companies indicates that implementing IFRS will significantly change the way these companies design and handle both their internal and external reporting activities, and further will increase the comparability of consolidated accounts as well as levels of transparency for many companies. The quantitative impact is only analyzed in three companies, which were the first companies to adopt IFRS in 2003. 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.

Van Tendeloo and Vanstraelen (2005) address the question of whether the adoption of IFRS is associated with lower earnings management. They examine whether German companies that have adopted IFRS engage significantly less in earnings management compared to firms reporting under German GAAP. Their result reveals that the adoption of IFRS cannot be associated with lower earnings management.

Adoption of IFRS has increased the quality of financial reporting among companies across the world as reveal in some extensive studies such as (Ezeani & Oladele, 2014; Van Adiba, et al. 2013; Thomas, 2012; Rahman, et al., 2010).

IFRS Adoption and Implementation Process in Nigeria

The Nigeria's Federal Executive Council (FEC) gave approval for the convergence of Nigerian Statement of Accounting Standard (SAS) with the IFRS from January 1, 2012. The adoption was organized in such that all stakeholders use IFRS by January 2014. According to the IFRS adoption Roadmap Committee (2010), Public Listed Entities and Significant Public Interest Entities are expected to adopt the IFRS by January 2012. All Other Public Interest Entities are expected to mandatorily adopt the IFRS for

statutory purposes by January 2013, and Small and Medium-sized Entities (SMEs) shall mandatorily adopt IFRS by January 2014. Nigerian listed entities were required to prepare their closing balances as at December 31, 2010 according to IFRS. The closing figures of December 31, 2010 will become the opening balances as at January 1, 2011 for IFRS based financial statements as at December 31, 2011. The opening balances for January 1, 2012 will be the first IFRS full financial statements prepared in accordance with the provision of IFRS as at December 31, 2012.

"It will be in the interest of the Nigerian economy for listed companies to adopt globally accepted, high quality accounting standards, by fully converging Nigerian national accounting standards with International Financial Reporting Standards (IFRS) over the earliest possible transition period, given the increasing globalization of capital markets".

IFRS vs. NIGERIAN GAAP

The Nigerian Statement of Accounting Standards (SAS) or Nigerian GAAP, the UK GAAP and IFRS are in many ways different in terms of guidance and application of the standards, although, some of these standards are similar or comparable in certain areas. Most of the SAS under NG-GAAP are found to be similar to Financial Reporting Standards (FRS) and Statement of Standard Accounting Practice (SSAP) under UK-GAAP. This could be attributed to the strong interrelationships in terms of accounting education, oil and gas, business, finance, banking as well as the colonial relationship between the UK and Nigeria.

IFRS Adoption and Financial Statement Disclosures

It is a statutory requirement for companies to provide supplementary information regarding the basis and justification for the preparation of their financial reports. Financial statement disclosures are secondary information provided by companies to clarify, interpret or justify certain published financial information. Disclosures normally provide further clarity of the financial information in order to assist users with additional information for the purpose of making informed

investments decisions in the business. Management also uses disclosures to attest to the accuracy and validity of reported financial information. Private companies are not required to disclose certain financial information regarding the company. Thus, listed companies are mandatorily required to disclose certain information regarding the company in order to fulfill the requirements of the Securities and Exchange Commission (SEC) and other regulatory bodies. Companies voluntarily disclose their financial information.

In Nigeria, the information disclosure requirements in the financial statements under NG-GAAP were grossly inadequate to effectively bridge the information asymmetry between companies and the users of the financial statements. However, reporting under the IFRS regime requires companies especially in the Oil and Gas sector to make more disclosures regarding their reserves, discoveries and other key variables necessary for investment decision and to meet objective of financial statements, which is to show a true and fair view of the activities of a company. It is therefore envisaged that the companies will disclose more of their financial information with the transition from the NG-GAAP to IFRS.

Challenges to be presented by IFRS Adoption

The IFRS is a global GAAP, setting principles-based and globally accepted standard published by the IASB to support those who adopted in the preparation and presentation a high quality, transparent and comparable financial statements that will aid easy interpretation. Okoye and Akenbor (2012), the perceived challenges to be presented by IFRS adoption and implementation includes: the intrinsic problems of aligning with IFRS pointed out that international accounting clearly has a language problem (Ukpai, 2002). Adams (2004) claimed that where an accounting standard conflict with government policy, the standard is revised such as the LIFO method of stock valuation not allowable for tax purpose in Nigeria. Another problem inherent with the adoption of IFRS is the universal tendency to resist change (NASB 2010). Gambari (2010) noted that the successful adoption of IFRS entails assessing technical accounting, tax implications,

internal processes, statutory reporting, technology infrastructure, and organizational issues.

Meaning of Convergence with IFRS

Convergence means to achieve harmony with IFRS. Precisely, the term convergence can be considered "to design and maintain national accounting standards in a way that financial statements prepared in accordance with national accounting standards draw unreserved statement of compliance with IFRS", i.e. when the national accounting standards will comply with all the requirements of IFRS. Convergence does not mean that IFRS should be adopted word by word, e.g. replacing the term 'true & fair' for 'present fairly', in IAS 1, 'Presentation of Financial Statements'. Such changes do not lead to non-convergence with IFRS. Convergence would enhance international capital flow more freely, enabling companies to develop consistent global practices on accounting problems. It will help standardize training and assure better quality on international accounting standard (Ikpefan, 2012).

Benefits of Convergence to IFRS

Globalization has prompted many countries to open their doors for foreign investment and as business themselves expand across borders, both the public and private sectors are expected to recognize the benefits of having a common understanding of financial reporting framework supported by strong globally accepted auditing standards. But suffice to say that some of the benefits include: i. Single Reporting – Convergence with IFRS eliminates multiple reporting such as IFRS, and Nigeria GAAP; ii. Greater comparability of financial information for investors as a result of transparent financial reporting of company's activities among sectors, countries and companies; iii. Greater willingness on the part of investors to invest across borders will enable entities to have access to global capital markets and eliminates barriers to cross-border listing. It will also bring in foreign capital flows to the country; iv. Common accounting standards help investors to understand available investment opportunities as opposed to financial statements prepared under different set of national accounting standards; v. Lower cost of

capital and more efficient allocation of resources; vi. Higher economic growth; vii. Convergence to IFRS gives opportunities for professionals to sell their services as experts in different parts of the world; viii. IFRS balance sheet will be closer to economic value because historical cost will be substituted by fair values for several balance sheet items, which enable corporate to know its true worth; ix. Convergence will place better quality of financial reporting due to consistent application of accounting principles and reliability of financial statements. Trust and reliance can be place by investors, analysts and other stakeholders in a company's financial statements.

Determinants of Financial Reporting Quality after IFRS Adoption

Conversion to IFRS is likely to affect financial reporting; it is only one of the determinants of overall accounting quality. Because other determinants will continue to differ across countries, it is possible that accounting quality will continue to differ across countries following IFRS adoption.

Naomi and Kevin, (2007) identified that legal and political systems are the major influence of accounting quality. But they stressed on accounting standards, financial market development, capital structure, and ownership and tax system as the major incentives that influence accounting quality.

Legal and Political Systems

Legal and political systems influence accounting quality in several ways. First, they affect accounting quality indirectly through accounting standards. Accounting standard setting is a political process, in which users of accounting such as tax authorities, banks, shareholders, managers and labor unions have significant influence on standard setters. In an effort to reduce the political influence on standard setting, in 2001, the IASC was replaced by the IASB. The IASB is responsible only to a non-profit organization, the IASC Foundation. Whittington (2005) and Armstrong et al. (2007) document several instances where governments of some EU countries strongly voiced their concerns about IAS 39. Under IAS 39, banks

must report fair values of their financial instruments and will thus experience increased volatility in their balance sheets and earnings. This may affect investor and regulator views of financial institutions' stability.

Legal and political systems also affect accounting quality directly, through enforcement of accounting standards and litigation against managers and auditors. La Porta et al. (1998) find that legal enforcement is higher in common law countries. Using their enforcement index, the international accounting research has found that accounting quality is higher in countries with a common law origin and high protection of shareholder rights. Hung (2001) finds that accrual accounting is more value relevant relative to cash accounting in countries with strong shareholder protection, but accrual accounting reduces the value relevance of financial statements in countries with weak shareholder protection. Francis and Wang (2007) find that earnings quality is higher for firms audited by Big 5 auditors compared to non-Big 5 auditors only in countries with strong investor protection.

Accounting Standard

The quality of accounting is determined by the quality of the accounting standards chosen (Naomi & Kevin, 2007). If the International Accounting Standards Board (IASB) continues to improve the quality of IFRS, we would expect financial reporting under IFRS to become increasingly value relevant, less earnings management and timely loss recognition and reliable. Comprix et al. (2003) find that positive market reaction to the news on the possibility of IFRS adoption in the EU is related to the number of new disclosures and accrual measures under IFRS relative to respective national standards. Burgstahler et al. (2006) also find that Comprix's index of new disclosures and accrual measures is significantly related to less earnings management in the EU. Thus, opponents argue that a single set of standards may not be suitable for all settings and thus may not uniformly improve value relevance and reliability, especially given differences among countries. For example, Ball (2006) discloses that pension accounting may be

subject to earnings management especially in countries that have less mature pension systems. Using a universal accounting method makes it less costly for investors to identify earnings management.

Financial Markets Development

The first financial reporting incentive that likely affects accounting quality is the development of financial markets. Demand for information results from market participants' need to reduce information asymmetry. Adverse selection happens when market participants cannot differentiate between good firms and bad firms. Without such differentiation, market participants would 'price protect' themselves by increasing costs of financing to firms, and thus only bad firms would be willing to finance at these high costs (Scout, 2005).

Accordingly, financial markets would mostly consist of bad firms. Spence (1973) finds that credible signaling can reduce this adverse selection problem. If signaling is more costly to low-quality firms, high-quality firms will signal to the market at lower costs and receive lower costs of financing. Financial reporting is a primary mechanism used to signal to the market. Francis et al. (2005) find that firms in need of external financing voluntarily disclose more information than a country's minimum requirement and have lower costs of capital. Similarly, Huddart et al. (1999) find that even though liquidity traders are risk-neutral, they prefer to trade on high disclosure exchanges, which in turn motivates firms to raise funds on a high disclosure stock exchange to exploit the liquidity and lower costs of capital at the exchange. Burgstahler et al. (2006) find that public firms in countries with large and highly developed equity markets engage less earnings management than private firms in these countries. They attribute this finding to either (1) stock markets providing incentives for firms to make earnings more informative to reduce costs of capital; or (2) stock markets screening out firms with less informative earnings. Thus, the demand for information from market participants provides incentives for firm managers to improve the quality of financial reporting.

Capital Structure

Legal and political systems also affect accounting quality indirectly through capital structures. In countries with high creditor protection, firms are more easily able to get bank financing at lower cost. In countries with high possibility of government expropriation and corruption, contracting is mostly completed privately to avoid social and political scrutiny, and financial reporting is a less frequently used method to reduce information asymmetry. Earnings quality is thus lower in countries with high dominance of bank financing and political risks.

Ownership Structure

Firms with concentrated ownership and high divergence between cash flow rights and control rights have low incentives for financial reporting. First, controlling stakeholders are active in management, thus reducing the demand for financial reporting. Ball and Shivakumar (2005), and Burgstahler et al. (2006) examine the earnings quality of private firms in Europe, which are normally controlled by a few shareholders and lenders. They find that earnings quality of private firms is lower than that of public firms, although both groups are subject to the same accounting, tax and auditing standards. They attribute the findings to low demand for high-quality financial reporting because stakeholders in private firms have easy access to firms' information. The low earnings quality of private firms also avoids leakage of proprietary information to the public and is thus an equilibrium outcome. Second, controlling shareholders have incentives to hide their exploitation of the wealth of minority shareholders. Pyramidal and cross-shareholding gives an ultimate owner dominant control over a firm without a large investment in ownership.

Legal and political systems may also affect earnings quality indirectly through ownership structures. La Porta et al. (1998) find that countries with stronger investor protection have a lower concentration of ownership. They argue that ownership concentration is a substitute for legal protection because: (1) shareholders need more control to avoid being expropriated by managers;

and (2) small investors are not interested in purchasing stocks due to less protection. Political systems also affect ownership structure. A government with prevalence of political rent-seeking may cause concentration of ownership.

Tax System

An important aspect of the legal system is the tax system. There are several ways that a tax system can affect earnings quality. First, earnings are less likely to reflect underlying business in a country with a close linkage between financial accounting income and taxable income (Guenther and Young, 2000). A close linkage between accounting standards and tax laws reduces the quality of accounting standards, since they serve political purposes such as collection of taxes for the government. Second, a high tax rate will increase the incentive to reduce taxable income. Taxable income and accounting income are linked even in countries with low book-tax conformity, such as the United States. Therefore, a higher tax rate will increase the incentive to hide profits in financial reporting. Burgstahler et al. (2006) find that European firms in high book-tax-alignment and high tax-rate countries manage earnings more. Third, a country's tax authority has statutory power in verifying a company's profits. Tax authorities do not have the same free-rider problem as shareholders because there is no beneficiary of tax collection other than the government. Haw et al. (2004) find that a country's tax compliance is associated with lower earnings management, and has a greater effect than judicial system efficiency in curbing earnings management.

CONCLUSION

This paper reviews the research on the roles and consequences of changing accounting standards from Local GAAP to IFRS and discusses determinants of financial reporting quality following IFRS adoption. The study finds that literature of IFRS adoption and international accounting has found a mix impact from voluntary and mandatory adoption of a single set accounting standard, IFRS. While some of the literature such as (Van Adiba, et al. 2013; Brochet, et al., 2012;

Thomas, 2012; Ezeani & Oladele, 2012; Asheq, Jira, & Hector, 2010) has found that adoption of IFRS has positive impact and increased the quality of financial reporting among companies across the borders. Thus, other literature found that the impact of IFRS adoption may relate to country-specific differences such as: the business and financial culture; accounting culture; auditing culture; regulatory culture; level of shareholder protection; jurisdictional settings across countries; and conflict between information preparers' incentives and standards. Such differences may affect the implementation and effectiveness of the IFRS convergence (Zeff, 2007; Lourenco & Curto, 2008). Due to the conflicting findings of IFRS implementation in developed countries, the prior studies do not provide valuable reference as to whether improved quality of information is achievable for developing countries still debating or considering the adoption of IFRS.

Similarly, an analysis of the determinants of financial reporting quality has significant implications for policy. Hence all countries will have consistent and single set of financial reporting rules; future improvements in accounting quality will be largely dependent on changes in a country's legal and political system, accounting standard and financial reporting quality incentives (financial market development, capital structure, and ownership and tax systems). This has been based on the review of accounting, economic and finance studies. For a country to change its overall institutional infrastructure is intricate, therefore concentration on financial reporting incentives will possibly be the simplest way to achieve further improvements in financial reporting quality.

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