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Full IFRS and IFRS for SMEs Adoption by Private Firms

Empirical Evidence on Country Level

Band 12

PL ACADEMIC RESEARCH

1 Foundation

1.1 Introduction

1.1.1 Motivation

*Which countries have **actually adopted** Full IFRS and IFRS for SMEs in the field of private firms and **why** have they done so?*

At a first glance, this question does not sound very challenging since the IFRS.org website presents adoption profiles for 130 jurisdictions worldwide. Moreover, the answer to the second part of the question could be given by simply applying common sense. Countries adopt IFRS[1] because today's economic transactions recorded in financial statements have increasingly become international. Raising capital or making business across national borders broadens the group of preparers and users of financial statements across the world. Hence, **adopting international accounting standards appears logical**. This phenomenon should generally affect all kinds of operations regardless of their legal form or size. However, as in some parts of the world local companies might be, to a certain extent, more globalized than elsewhere, the demand for internationally converged and comparable financial reporting standards is likely to vary among firms and countries alike.

For this reason, **not every country in the world has yet adopted IFRS**. Even if the majority of domestic companies strive for IFRS adoption, the countries in which they operate might hesitate to give up legislative power to a supranational organization if the expected outcome is unfavorable. Other countries may only abide by such a decision because they have been put under certain pressures.

The largest and most homogeneous demand for global financial accounting[2] rules certainly exists for companies that seek funds from global capital markets. Apart from their business partners, their owners and/or creditors are spread over the entire world. In such a setting, globally converged accounting standards become indispensable. Unsurprisingly, the harmonization of financial reporting began with exactly those entities. Since the early beginnings of the IASC in the 1970s, the International Accounting Standards (IAS), and from year 2002 onwards the 'Full' International Financial Reporting Standards (**Full IFRS**), have become the predominant accounting language for **listed companies** in more than 130 countries and jurisdictions by 2014 (*Deloitte Touche Tohmatsu* (2014c)).

Although accepting the wide diffusion of Full IFRS as a matter of fact, *Nobes* (2013) specifies the above phrase as follows: *"The consolidated statements of the majority of listed companies in about 90 countries are either required to comply with IASB-IFRS, or choose to do so"* (*Nobes* (2013), p. 103). In fact, the definition of 'IFRS adoption' is not as simple as it seems. It can actually mean many different things. When *Nobes* points out his caveats to statements such as *"IFRS have spread to over 100 countries"*, he wants to draw attention to the **'how' of IFRS adoption**. In order to assess correctly to which extent a country has adopted IFRS or not, it is important to consider which version of IFRS has been adopted

1 The term 'IFRS' is used as a hypernym for 'Full IFRS' and 'IFRS for SMEs'.

2 The terms 'financial accounting' and 'financial reporting' will be used synonymously in the following.

and if it has been modified or complemented by local requirements (e.g. EU-IFRS and Australian IFRS). Furthermore, IFRS adoption does not describe the same local conditions if in one country IFRS have become the only mandatory accounting framework for all domestic companies whereas in another IFRS are just one of several different sets of accounting rules local firms are allowed to choose from. It can also be differentiated between countries that have adopted IFRS for all domestic companies or only for a certain type of entities (e.g. listed companies). Finally, IFRS adoption might be restricted to consolidated accounts, because individual financial statements are still heavily influenced by local company or tax law.

As globalization proceeds, the demand for globally converged accounting standards increases for companies acting within and beyond capital markets. As a result, Full IFRS have also been adopted by **private firms** in nearly 100 countries worldwide (*Deloitte Touche Tohmatsu* (2014c)). One could argue that by offering one set of International Financial Reporting Standards (i.e. Full IFRS) to both listed and private companies, the IFRS Foundation had already fully served its purpose. However, in July 2009, something remarkable happened: the International Financial Reporting Standard for Small and Medium-sized Entities (**IFRS for SMEs**) was issued.

Considering the difficulty in precisely defining IFRS adoption, an additional version of IASB-IFRS undeniably adds complexity to this topic. Furthermore, different versions of IFRS are regarded as one reason for the survival of international differences under IFRS (*Nobes* (2006), p. 236). By developing a second set of IFRS, which is meant to be exclusively adopted by companies without public accountability, the IFRS Foundation might violate its principal objective to *"develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB"* (*IFRS Foundation* (2014g)). Although the *IASB* denies this contradiction by pointing out that 'single set' only refers to entities in similar circumstances (*International Accounting Standards Board* (2013), BC42), the *IASB* members faced a true **dilemma** when putting the IFRS for SMEs on their agenda:

> *"On the one hand, it believed that the same concepts of financial reporting are appropriate for all entities regardless of public accountability. […] This suggested that a single set of accounting standards should be suitable for all entities. […] On the other hand, the Board acknowledged that differences in the types and needs of users of SMEs' financial statements, as well as limitations in, and the cost of, the accounting expertise available to SMEs, suggested that a separate standard for SMEs is appropriate. […] On balance, the Board concluded that the latter approach (separate standard) was appropriate."*
>
> (*International Accounting Standards Board* (2013), BC47)

Despite the fundamental doubts about the reasonableness and the net economic benefits of an IFRS for SMEs, which caused considerable controversies about the new standard,[3] the **global impact of IFRS for SMEs** on the financial reporting of private firms is **re-**

[3] Cf. *International Accounting Standards Board* (2013), DO1-DO6, for the dissenting opinion of James J. Leisenring.

markable. Only a few weeks after its publication in 2009, the IFRS for SMEs was already expected to have *"the potential to revolutionise and harmonise financial reporting by private companies across the world"* (*Grant Thornton* (2009), p. 1). Within fewer than three years, IFRS for SMEs was expected to be adopted in over 80 countries (*IFRS Foundation* (2012a), p. 1). According to former *IASB* member *Paul Pacter*, millions of small companies were already using the IFRS for SMEs by 2012 (*IFRS Foundation* (2011), p. 2). Regardless of the reliability of this number, there is no doubt that since 2009 millions of private firms have at least been given the possibility of adopting the IFRS for SMEs.

While countries such as South Africa, Singapore, or the United States adopted the IFRS for SMEs shortly after (or even before)[4] its issuance, the European Union has not approved IFRS for SMEs as a legitimate accounting framework for European private firms by 2014. Some EU member states have still begun to align their **Local GAAPs** with IFRS for SMEs to an extent that it does not conflict with EU law (e.g. Estonia, Sweden). In spite of that, many national GAAPs of European, African or Asian countries had already been more or less converged with IAS and/or Full IFRS during the past four decades (*Pacter* (2009b), p. 29).

Without a doubt, the **IFRS for SMEs** has mixed up the bipolar financial accounting landscape between Local GAAPs and Full IFRS by adding a **third dimension** to international GAAP choice. As a result, standard-setters and parliaments all over the world are urged to rethink their previous Full IFRS convergence strategies by incorporating IFRS for SMEs into their local financial accounting framework. As pointed out above, there are several alternative ways to adopt Full IFRS and/or IFRS for SMEs in a country's local financial accounting environment. Even though the *IASB* favors complete adoption (*Pacter* (2012), p. 20), it cannot deny that both Full IFRS and IFRS for SMEs have been adjusted to local needs in various jurisdictions (*Pacter* (2014), p. 9), which makes inter-country IFRS comparisons a challenging task. *Hans Hoogervorst*, Chairman of the IASB, often uses the phrase, *"we must speak the same accounting language"* (*Hoogervorst/Teitler-Feinberg* (2012), p. 322). Given the local modifications, carve-outs, and supplements, it seems that IFRS have already become a language with strong dialects. The rise of IFRS for SMEs creates additional **diversity** and **complexity** in the field of private firms.

In contrast to the extensive firm level research that has been conducted so far on the adoption of Full IFRS in the context of listed companies, **little attention** has yet been given to **country level research** on the adoption of Full IFRS and IFRS for SMEs in the field of private firms. Instead, prior research was mostly dedicated to the firm- and country-specific determinants and the economic consequences of Full IFRS adoption by listed companies (e.g. *Gassen/Sellhorn* (2006); *Barth et al.* (2008); *Daske et al.* (2008)). Furthermore, studies on the firm- and country-specific determinants of differences in accounting practice under Full IFRS have become an increasingly important research area (*Jaafar/McLeay* (2007); *Kvaal/Nobes* (2012); *Wehrfritz et al.* (2012)). As far as IFRS for SMEs adoption is concerned, the majority of the empirical, mostly survey-based research has so far focused on firm level analyses covering the due process (*Kajüter et al.* (2008)) and the hypothetical implications of IFRS for SMEs adoption (*European Commission*

[4] South Africa adopted the ED-IFRS for SMEs in 2007.

(2010); *Fülbier/Gassen* (2010); *Litjens et al.* (2012)). Country level studies on the de facto determinants of IFRS for SMEs adoption are still rare (*Kaya/Koch* (2013)). This study therefore contributes to the **scarce empirical, cross-country research** that has so far provided evidence on the country-specific characteristics (e.g. *Deloitte Touche Tohmatsu* (2014c)) and determinants (e.g. *Hope et al.* (2006); *Judge et al.* (2010); *Ramanna/Sletten* (2013)) of Full IFRS and IFRS for SMEs adoption in the field of private firms.

1.1.2 Research questions

This study addresses the following two main research questions:

(1) *How are accounting systems shaped in the field of private firms?*

(2) *Why do countries adopt Full IFRS or IFRS for SMEs in the field of private firms?*

The **first research question** shall be answered by applying two different empirical research strategies: *time series analysis* and *cross-sectional analysis*. For a sample of 110 countries, the study first displays the *process* of worldwide Full IFRS and IFRS for SMEs adoption in the field of private firms since 2002 and thereby identifies different types of accounting systems for private firms. The time series analysis classifies accounting systems for private firms according to their overall degree of compliance with Full IFRS and IFRS for SMEs and thus identifies to which extent these accounting systems have been converged with Full IFRS or IFRS for SMEs since 2002. For the same 110 countries, the cross-sectional analysis provides insight into the *status quo* of local Full IFRS and IFRS for SMEs implementation in 2014 and presents a detailed overview on the similarities and differences regarding the local implementation of Full IFRS and IFRS for SMEs across the globe.

The **second research question** shall be answered by conducting *three cross-sectional analyses* that reveal which factors have determined a country's decision to adopt Full IFRS and IFRS for SMEs in the field of private firms at two different points in time (2008 and 2014). The cut-off date of the first analysis is 2008, as this was the last year before the IFRS for SMEs was issued. Hence, this study tests the explanatory power of various factors that determined the probability of Full IFRS adoption in the field of private firms at a time where Full IFRS were the only IASB standards in place. The second cross-sectional analysis then examines how the previously identified determinants of Full IFRS adoption change if the years 2009 to 2014 are included in the analysis. The study hereby takes into account the time after the IFRS for SMEs has been issued and aims at analyzing the interdependencies between the two IASB standards. Finally, it is examined which factors have determined the probability of IFRS for SMEs adoption between 2009 and 2014.

The **research fields**, which are addressed within the two sub-studies, and the regarding research approaches are summarized in Figure 1-1.

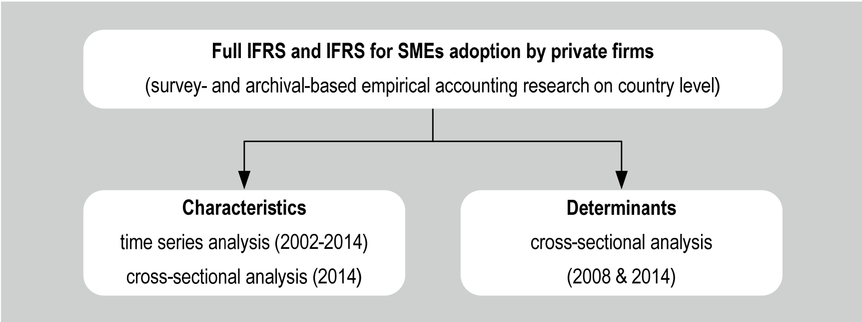

Figure 1-1: Research fields of the study

The study's **contribution** to accounting research, regulation, and practice is manifold. While extensive research was conducted on the determinants and consequences of Full IFRS adoption by listed companies – both on firm and on country level – cross-country accounting research dealing with Full IFRS and IFRS for SMEs adoption by private firms is still at an early stage (*Nobes* (2010), p. 217; 222). Hence, this study closes a current research gap in the area of international accounting harmonization (IAH) research by providing an insight into the country level characteristics and determinants of Full IFRS and IFRS for SMEs adoption by private firms. It is the first study that analyzes in detail the *process* towards Full IFRS and IFRS for SMEs adoption in the context of private firms since 2002 by applying a unique classification methodology. Furthermore, the study provides the most detailed information available on the *status quo* of the two IASB standards' local implementation in 110 countries. Thirdly, it adds to the scarce empirical research that has yet been conducted on the determinants of Full IFRS and IFRS for SMEs adoption in the field of private firms.

The empirical results of the descriptive and explanatory research can help the **IASB** to develop a clearer picture of the shape and the driving factors of worldwide Full IFRS and IFRS for SMEs adoption in the field of private firms. They may thus enable a better understanding of the remaining constraints and difficulties in the global adoption process. Such an understanding is vital to predict any future steps by national regulators in the field of global harmonization of financial reporting, especially regarding private firms.

By describing the characteristics of Full IFRS and IFRS for SMEs adoption on country level, the first sub-study raises the awareness of **IFRS for SMEs' growing impact** on the financial reporting of private firms worldwide. It addresses both countries that have already adopted the standard (e.g. Brazil, Singapore, and South Africa) and those that have yet been rather critical of IFRS for SMEs adoption (e.g. Germany and France). Furthermore, the findings are relevant for all jurisdictions, where IFRS for SMEs has already been formally adopted, but de facto adoption has not gotten under way yet (e.g. United States).

The empirical results allow for various benchmark analyses and highlight which countries are ahead of their peers and which jurisdictions lag behind in terms of international financial accounting harmonization. **National standard-setters** can make comparisons on a region-by-region or country-by-country level and put their own adoption patterns in perspective to the adoption process in other jurisdictions. With regard to the extent of local financial accounting systems' convergence with Full IFRS and IFRS for SMEs, the study provides surprising insights into the dynamics of financial accounting harmonization in the field of private firms and the substantial change of the international financial reporting landscape during the last decade.

By identifying economic and institutional determinants of Full IFRS and IFRS for SMEs adoption, the study provides national regulators and policy-makers with recent information on the **key drivers of their adoption decisions**. In particular, the study reveals why some countries adopt the IASB standards although they expect only little economic benefits from it. Standard-setters and other regulators can therefore reflect on and reassess their own adoption decision and discuss whether Full IFRS or IFRS for SMEs is (or would be) the most favorable accounting system for their jurisdiction.

The empirical results may also be of interest for private firms' **corporate managers** who are responsible for their company's financial reporting or for the internationalization of their business. Local financial reporting requirements are one of the most important confounding factors when it comes to the internationalization of small and medium-sized businesses. Knowing about the current developments in the regulatory environment of the targeted jurisdictions can be crucial for the success of private firms' internationalization strategy. For this reason, the study is not only relevant for macro-level policy makers but also for decision makers in private companies.

Before elaborating on the scientific research strategy and the conceptualization of the conducted research, the following section summarizes the further outline of the study.

1.1.3 Outline

Based on the above comments on the study's motivation, its research questions and contribution, **chapter one** continues with a description of the scientific research strategy and the conceptualization of the conducted research. This step is necessary to explain the reasons why a certain research methodology has been chosen in this study. Subsequently, chapter one provides the conceptual grounding of the study. In a first step, an introduction in the financial reporting of private firms is given. Secondly, the process of international accounting harmonization is examined and the two relevant international accounting systems (i.e. Full IFRS and IFRS for SMEs) are depicted. The study continues with a presentation of the research field and a review of prior research.

Starting from the *economic theory of networks* and the *institutional theory of isomorphism*, **chapter two** develops hypotheses on why countries choose to adopt Full IFRS and IFRS for SMEs in the field of private firms. The two theories underline the theoretical association between the adoption of international accounting standards (Full IFRS and IFRS for SMEs) by countries and the economic benefits, network effects, and institutional pressures these countries are subject to.

Chapter three presents the research design and the empirical results of the first sub-study. The first section describes the conceptual methodology and the data used to fully **charac-**

terize Full IFRS and IFRS for SMEs adoption in the field of private firms. The second section includes the empirical results, which are presented separately for the following nine geographic regions:

North America	European Union	Middle East
Central America & Caribbean	Southeast Europe	Asia
South America	Africa	Australia & Oceania

The chapter ends with a discussion, which integrates the main findings.

Chapter four comprises the research design and the empirical results of the second sub-study, whose focus is on the **determinants of Full IFRS and IFRS for SMEs adoption** in the field of private firms. Having presented the assumptions and variables used in the statistical analyses, the chapter provides descriptive statistics, bivariate, and multivariate findings for three distinct cross-sectional analyses (Full IFRS adoption by 2008 and by 2014 and IFRS for SMEs adoption by 2014). The chapter ends with a discussion of the empirical results, in which interrelationships between the three analyses are established.

The empirical results presented in chapter three and four are briefly summarized at the beginning of **chapter five**. Implications are derived for the IASB and national standard-setters, global policy-makers, corporate managers, and preparers of private firms' financial statements. Moreover, the section highlights the limitations of the study and presents suggestions for future research. Finally, chapter five provides an outlook on future developments in international accounting harmonization in the field of private firms.

The entire outline of the study is displayed in Figure 1-2.