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The Adoption of IFRS and Quality in the Accounting Profession. Theoretical Analysis in the Case of German Companies

A. M. Paşcu

Ana-Maria Paşcu
"Alexandru Ioan Cuza" University, Iaşi, Romania

Abstract
The processes of normalization, internationalization, harmonization and convergence have become a nowadays reality. As a result, the massive adoption of IFRS in many regions of the world has generated numerous debates and opinions. Under these circumstances, ever more attention was given to the connection between the international accounting/audit standard and quality in the accounting profession, the main characteristic of the business world. Therefore, through this study, we aim to identify the effects of adopting the International Financial Reporting Standards (IFRS) on quality improvement in the accounting profession.
Keywords: IFRS adoption, quality in the accounting profession

Introduction

Economic activity is an extremely complex field. Globalization and competition determine an increase in the role of information as well as in supporting decisions. *Information quality* influences both: the efficiency of decisions and the perspective of obtaining good results in the company's activity. Moreover, numerous authors adhere to the opinion that reporting this information in compliance with the International Financial Reporting Standards (IFRS) contributes to increasing quality in the accounting profession and implicitly to provide the best quality information.

In the attempt to define the quality of accounting standards, numerous authors, in representative specialized studies, have treated this aspect through the perspective of the connection with the quality of the financial statements, drawn according with the international standards in that field.

Analyzing the situation in Germany, in this study we focus on the complex interaction between stimuli and accounting standards in determining quality in audit and in the accounting profession. Although the sample size is relatively small in the case of the analysis performed on a single country, this issue is compensated by the fact that we can explicitly notice the voluntary adoption versus the rejection options of all the companies involved.

In essence, we perform an analysis on the situation in this country since it allows us to test the extent to which quality in the accounting profession is improved when companies are forced to comply with what is generally perceived as a high quality accounting standard. It is a known fact that this country is subject to a Roman-German law system and, implicitly, to a continental accounting system, dominated by prudence, dependent on fiscality, and with limited investor protection.

Although the application of IFRS has become compulsory in Europe starting with January 2005, many German companies were already using the international standards for drawing the financial statements, some since 1994 and many other since 1998 and 1999. For example, relating to the total number of quoted companies, in 1998, 42 companies of the total 597 (7.04%) applied IAS/IFRS, 37 companies (6.2%) applied US-GAAP, and the rest of the companies were using HGB.

The researchers Weiβenberg, Stahl and Vorstius (2004) focused on identifying the reasons why some German companies gave up the German GAAP in favor of the IFRS or of the US-GAAP. The authors sent a questionnaire to 359 companies (DAX 100 and Neuer Markt) and received 81 answers. The results obtained showed the fact that the switch to the application of international norms was mainly motivated by the wish to improve the quality of the information provided, and implicitly by the desire to obtain higher gains on the capital market and with the purpose of attracting external investors.

Material and methods

In order to meet the aimed desideratum, we performed a theoretical analysis of the representative specialized literature, on the subject of the influence of the International Financial Reporting Standards (IFRS) on the improvement of quality in the accounting profession. As a result, we wish to compare the way in which quality in the accounting profession is influenced by the adoption of IFRS for two groups of companies: those that gain net benefits from the adoption of IFRS and those that have not received stimulants in order to adopt the IFRS and had to comply with them.

The specialized literature review is completed by the critical comparative analysis and by inductive and deductive reasoning. The study brings into discussion obvious elements, as well as elements that are harder to grasp, based on which we can consider that the adoption of the international accounting reference is a measure that increases quality in the accounting profession.

Literature review

The problem of the connection between the accounting standards and the quality of audit was the object of numerous studies, like those from Van Tendeloo Brenda, Vanstraelen Ann (2005) - Belgium, Barth Mary, Landsman Wayne, Lang Mark, Williams Christopher (2006) - California, Gassen Joachim, Sellhorn Thorsten (2006) – Berlin. The researchers focused on the analysis of the impact of two dimensions of quality in the accounting profession, which are: *the benefits management and the loss of opportune acknowledgement*, often analyzed and debated in studies on the effect of accounting and audit standards on the quality of the accounting profession.

Moreover, the results suggest that the adoption of IFRS, which are generally seen as better than HGB from the quality perspective, does not necessarily lead to higher quality in accounting. There are two possible explanations for this observation. First of all, the flexibility incorporated in IFRS would make them inefficient in managing the limitation of the benefits of the companies with a low level of stimulants. Secondly, IFRS may not be enough to reduce benefit management and to increase the loss of opportune acknowledgement. In this case, the improvements of the accounting quality noticed, based on the analysis of the tested sample could be transformed by changes in the company stimulants, close to their adoption. Although we cannot distinguish the difference between these explanations, they both comply with IFRS as such, without increasing accounting quality, even when the previous accounting standards are considered to be of lower quality.

However, supplementary tests confirm the existence of effects, in time, of an improvement in the quality of the accounting profession during the analyzed period, on the sample subject to the study. Nevertheless, this result does not explain the entire difference in the quality changes that we have noticed between the two groups, as part of the sample, one made up of selected companies and another one of voluntary companies. The fact that the time effect has an influence on the companies, irrespective of the accounting standards, further analysis supports the conclusion that improvements in the accounting quality in the case of the volunteers for the IFRS application can be attributed to the standards themselves.

In associated specialized studies, Ball, Robin, and Wu (2003) provide pragmatic evidence at the country level that accounting quality is influenced more by stimulants than by accounting standards. The authors argue that stimulants are influenced by the institutional situations of the companies. Moreover, Ball and Shivakumar (2005) and Burghstahler D.C., Hail L., Leuz C. (2006) underline the fact that quality in accounting is weaker in private companies than in the public ones, although the same accounting standards have been applied. In most countries, the accounting standards are the same for all the listed companies, but the stimulants often vary.

In another specialized study, Hans B. Christensen, Edward Lee, and Martin Walker (2008) suggested that the objective of improving the quality of the accounting profession cannot be met by all the companies by making the accounting standards compulsory, since such attempts will have limited effects on the companies that do not have stimulants to comply with the requirements.

The adoption of IFRS and quality in the accounting profession. Theoretical approach in the case of Germany

The conclusions of the researchers Van Tendeloo Brenda, Vanstraelen Ann (2005) and Goncharov Igor (2005) showed that no difference could be found in the benefit management between the German companies that voluntarily adopted the IFRS before 2001 and the German companies that applied HGB. Also, the authors did not identify differences in what concerns the manipulation of the results between the companies that voluntarily adopted the international standards before 2001 and those that continue to apply the German Commercial Code. Contrarily, the switch to the international norms appears to increase the number of result manipulation practices. However, they are fewer when the company benefits from contractual relations with an auditor from the Big 4.

Hung and Subramanyam (2007) reached a similar conclusion for a sample of German companies that voluntarily adopted the IFRS between 1998 and 2002. Rather than focusing on the transversal differences between companies, Hung and Subramanyam capitalized upon the fact that the companies that adopted the IFRS compare their net income under the application of HGB and IFRS for the same years. Since IFRS is associated with higher accounting quality, Barth et al. (2006; 2008) discovered, by analyzing a sample of international companies that voluntarily adopted the IFRS before 2003, the fact that they present lower levels of benefit management and less loss of the opportune acknowledgement than a similar group of companies that use the local accounting norm system.

In conclusion, the proof regarding the association between the voluntary adoption of IFRS and quality in the accounting profession is mixed, although the documents that use more recent data generally find higher accounting quality in the case of companies that adopt IFRS, irrespective of whether or not this step took place voluntarily or compulsorily.

The common feature of these studies is the fact that they focus on the companies that have voluntarily adopted the IFRS. This aspect raises a few questions, which we believe to be important, which are: whether or not *we can attribute the quality improvement to the application of the IFRS in itself*? *Does the adoption of IFRS have considerable effects on quality in accounting? Are quality improvements the result of other changes simultaneously implemented by the adopting companies?*

In a parallel study, Daske Holger, Luzi Hail, Christian Leuz and Rodrigo Verdi (2007) verify the effects of market capital on the compulsory adoption of IFRS. The authors find evidence that correspond to the reduction in the information asymmetry in association with the compulsory adoption of IFRS. They debate the possibility for the effect to come from associated network causes, rather than from improvements of the accounting quality. Nevertheless, Daske et al. notice that the effect of adopting IFRS is concentrated in companies with stimulants.

In a similar spirit, Hans Christensen, Edward Lee and Martin Walker (2008) support the hypothesis that, if the adoption of IFRS has a beneficial effect on quality in accounting, then the companies in countries with a low quality level also present dependences on fair funding before the compulsory adoption of IFRS. As a result, they should feel a positive qualitative impact after the compulsory adoption.

Nevertheless, numerous studies show that, using the implicit cost of fair capital as an indicator, no effect can be noticed for these countries, even after two years of usage of the new accounting standards. Still, we consider that the involuntary adoption of these standards, in the conditions of complying with the legal requirements imposed by the international normalizers, generates an increase in the quality of the accounting profession and, implicitly, in audit.

We therefore believe that *the voluntary adoption imposes quality changes in the accounting profession,* especially because the purpose of financial reporting is in essence to reduce the information asymmetry between the corporate managers and the contracting parties. Moreover, the latter may be shareholders, creditors, providers, customers, employees and other shareholding companies. As financial reporting come to facilitate efficient contracting, maximizing the company value, the relative importance of the various user groups and their different information needs influence the way in which a manager applies the evaluation margin in financial reporting. Let us assume then, that a company experiences a positive shock to its options of economic growth. In order to capitalize upon these new growth opportunities, the company needs external funding. The involvement of foreign investors is easier when the benefits are not managed and when losses are acknowledged in due time (Ball R., Kothari S.P., Robin A., (2000); Watts R.L., (2003)).

As a result, in order to attract external funds, companies must improve their financial reporting according to these two dimensions. In this scenario, two vague categories of explanations are essential in what concerns the reason why a company can voluntarily adopt the IFRS in the process. The former suggests that the IFRS have a beneficial effect on quality in the accounting profession, while the second claims that it is the action of other factors that have an effect on the company.

The previous statements do not remain valid in the conditions in which *the compulsory IFRS* have been adopted according to the "*checkbox" mentality*. Moreover, for the companies that delayed the adoption of the IFRS until 2005, when it became compulsory, the circumstances related to its adoption differ from those valid for the companies that voluntarily adopted these accounting standards. Companies could adopt the IFRS ever since 1998, but they decided to wait until they had to do it, in 2005.

In the study *International Financial Reporting Standards - ready for take-off?* (2004), Pricewaterhouse Coopers representatives suggest that the extent to which the IFRS is incorporated into the organization is an important factor in the resulting accounting quality. Moreover, IFRS is considered to be incorporated if it is used for internal reporting and if the systems are adapted to automatically generate the required information.

Similarly, the extent to which the IFRS is incorporated into the organization may also affect the conformity costs, since the change of internal reporting and the adaptation of the IT systems are extremely expensive. The idea that the "checkbox" mentality is common among the companies that adopted the compulsory IFRS is supported by a study of the first 200 IFRS annual reports obtained from all the EU member states (ICAEW, 2007).

Trying to identify the manner in which the application of international standards may be associated to an increase in the quality of the accounting information and, implicitly, of the accounting profession, the authors Barth M., Lansman W., Lang M. (2006) analyzed a sample of 21 countries that adopted the IAS between 1994 and 2003. Their conclusions were that, for the fiscal years after the adoption of the international reference, companies reduced their result manipulation practices, acknowledged time losses, and the relevance of the numbers presented in the financial statements amplified. They also noticed that, after the adoption of IAS, the variations of the modifications of the net income and cash flow increase, the interdependence between engagements and cash flows grows the frequency of appearance of positive net results decreases and that of losses increases. All these were associated to an increase in the quality of the accounting information and of the relevance of the results after IAS implementation.

Results and discussion

Previous research showed that benefit management decreases and the loss of opportune acknowledgement increases after the voluntary adoption of the IFRS. In contrast, the companies that delayed the adoption until it became compulsory in 2005 did that because they did not have the necessary stimulants for adopting the IFRS. We cannot find any improvement in the accounting quality for the companies that resisted the adoption of IFRS until 2005. Although additional analyses indicate that quality improvements among the companies that voluntarily adopted the IFRS were affected by temporal tendencies, this effect does not explain some of the quality changes until the adoption moment between the two groups. We believe that the quality effect in the accounting profession does not always improve with the adoption of the IFRS, but this can be a measure to rally to the international information market.

Conclusion

Numerous studies showed that one of the reasons why Germany voluntarily adopted the International Accounting Standards since 1997 was the fact that the use of these standards can be considered an indicator of the quality of the published information. Also, renowned audit companies (Big Five, at the time) encouraged the use of international norms by their customers, so as to be able to make scale economies as a result of the application of a single set of accounting rules by customers worldwide. Another reason that lied at the basis of the adoption of international norms was the reduction of the information asymmetry, by publishing a large volume of information, their ability to inform the participants to capital market and increasing informational transparence.

After reviewing specialized studies, we noticed that the voluntary adoption of the IFRS is associated to benefit loss management and to the loss of opportune acknowledgement. In contrast, we cannot find any proof of improvement in the quality of the accounting profession for the companies that were forced to adopt the IFRS. However, we consider that the adoption of these standards, irrespective of the chosen manner, voluntary or involuntary, in the conditions of complying with the legal requirements imposed by international normalizers, generate an increase in the quality of the accounting profession and, implicitly, in audit.

All the results obtained shows the fact that the switch to the application of international norms was mainly motivated by the wish to improve the quality of the provided information and, implicitly, from the desire to obtain higher benefits on the capital market and with the purpose of attracting external investors.

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