The Effectiveness of International Financial Reporting Standard on the European Union

Sarhad Hamza Khdir[1]

[1] Raparin University, Director of Career Development Centre, Ranya, Iraq
Correspondence: Sarhad Hamza Khdir, Raparin University, Director of Career Development Centre, Ranya, Iraq. Email: Sarhadhamza@raparinuni.org

Received: October 31, 2016 Accepted: November 20, 2016 Published Online: December 1, 2016

Abstract: The objective of mandatory adoption of IFRS is to enhance the quality of accounting information in worldwide. However, this effort made challenged for European Union as a supranational body to achieve similar advantages of converged the IFRS standards. This study examines the effectiveness of IFRS on the European Union as a supranational body and whether the EU has successfully converged to the IFRS standards. The paper will also analyze if there are any difficulties with switching to the IFRS standards versus the traditional local accounting practices in EU. The results obtained show that the first application of IFRS has adopted among EU countries and the results indicate that the adoption of IFRS leads to improvement in value relevance. The results also imply that the IFRS adoption for EU does not ensure better quality of accounting information and standardized IFRS is not effective to implement for all EU because there is a lot of misperception in terms of these guidelines for preparing financial statement. The culture difference among EU shows that IFRS is not fits size standard for all EU that can lead EU to conform at the same time. The conclusion of this report will provide the answer whether it is or not effective for the EU to fully converge to the IFRS standards as a whole.

Keywords: Accounting, European Union, Financial Accounting, Converged IFRS

1. Introduction

In today's globalized world, there are many multinationals, capitalistic sharks and innovative startups operating and trading billions in assets, funds, dividends, real estate, etc. Certain attention needs to be brought up for the convergence of the international accounting. Along with the convergence, there are many advantages, but also pitfalls due to the exterior factors such as culture, political and legal system, government intervention and the information available. More and more countries are adopting or in the process of converging with the IFRS (International Financial Reporting Standards) and IASB (International Accounting Standards Board). At the present time, 28 countries in the European Union adopted according to the IFRSThe European Union was formed in 1993 and was the result of a merger of the European Economic Community, the Coal and Steel; and Atomic Energy community and that was the beginning of a supranational political entity whereby the power and decision-making will lie within all the governments of the EU (Carmichael & Lynford, 2012). The question is whether the EU, this big power bloc striving to complete with the US and China can successfully operate globally and internally with a standardized set of rules, ignoring the local accounting standards. The main objective of the IASB is to create certain standards that will be accepted globally and will aid towards a better communication and understanding in terms of international reporting and the EU plays a big role in this as they are considered as one big political and economical power (IFRS Foundation, 2014). For a more efficient and effective integration of the EU, the financial statements, annual reports, income measurements, accrual accounting, inventories and the cost of goods sold need to match to avoid discrepancies. The terminology and the format need to be considered as well so that all the countries of the EU are on the same line.

2. Literature Review

International Financial Reporting Standards (IFRS) followed by the International Accounting Standards Board (IASB) which is universal set of financial coverage standards around the world (IFRS Home page, 2016). Previous studies show different consequences of the IFRS on European countries. According to Adibah (2013), the adoption of IFRS by EU" started their transition in 2002 and it ended in 2005". The need for setting a single accounting standard is the reason for adoption of IFRS by EU (Barth, 2008). Epstein (2008) stated that the mandatory of adoption IFRS by EU has given them significant advantages in term of market liquidity, reduce transaction costs for capitalists. However, the research conducted by Guggiola (2010) stated that the lack of uniformities in IFRS among countries has led toward increasing compliance costs and scarce ability of comparing companies' performances. Callao (2009) also found that the first adoption of IFRS has had different effects on the financial reporting among countries, similarly, Narktabtee and Suntaree (2011) stated that, the IFRS application did not make an impact of the quality information for those countries that followed IFRS and the quality of accounting information depends on the "firm characteristics, which influence financial reporting incentives". However, Kaserer and Klingler (2008) explained that the adoption of IFRS among countries was beneficial for reducing risk of insiders and increasing trade in good and services. He concluded the research that the first adoption application of IFRS improved accounting "based assessment of executive performance". Although researchers and users agree upon benefits of IFRS as an accounting standard body, others still argue that the convergence of IFRS is hard to achieve for all EU because of the environmental and cultural differences among the companies. In our research paper, we examine the effectiveness of IFRS on the European Union as a supranational body and whether the EU has successfully converged to the IFRS standards.

2.1 Analysis How EU Adopted IFRS

In 2005, international accounting standard board (IASB) toward setting global accounting standards issued an International Financial Reporting Standard (FRS). Currently, 95 countries across the world require applying IASB to prepare financial reporting. At the present time, 28 European Union countries in euro zone adopt IFRS, and EU is a member of the group of twenty (G20). The governing bodies in the EU includes " the Council of European Union, the European Commission and European Parliament". These bodies are responsible for making the jurisdiction of the EU. The Council has responsibility to solve problems of EU. EU acted some laws about accounting for whole members of the EU have to comply it. The EU minister of IFRS passed rule and regulation in 2002 for whole members of the EU, while making the consolidate financial statement required in 2005. The European Union parliament was accountable to accept the laws for those countries follow IFRS for preparing financial reporting. In order to simplify IFRS for nations, the Europe commission had translated IFRS for them. However, the language of EU is different and includes 23 official language, a new language translation versions are available for whole members to present financial reporting instead of one single language (Bruggemann et al., 2013). Although, The European Union differed in many aspects such as social, legal, political, cultural and economical, they already adopted convergence accounting standard. The effects of globalization were a reason for EU to adopt the uniform accounting standard because most of them have different culture background and political systems. Recently, 28 countries in euro zone have many significant differences while they still adopted International reporting standard IFRS for consolidation financial statement. On one hand, the US have adopted own financial accounting standard board (FASB) which is different form IASB foundation IFRS. In 2010 the US Security Exchange Commission (SEC) stated strong commitment to a single set global accounting standard and it mentioned that IFRS will be the best positioned to serve the US markets, and users of financial reporting. On the other hand, more recently the SEC explained the effect IFRS on US market but it did not make a recommendation how, or when US should adopt IFRS. In addition, Since 2002, the European Union(EU) adopt IFRS for consolidated financial statement for whole companies, such as large companies and some medium size companies(SMS) that trade in the market. Similarly, for domestic companies wholes that securities trade in the public market, they have to prepare their financial reporting according to IFRS. For those forging companies that securities trade in t that are publicly traded in the EU markets permitted to prepare their financial statement according to local standard such as General Accepting Accounting Principle (GAAP) but they have to make equivalent to IFRS. Harmonized accounting standards provide many benefits for EU countries such as compare financial statement quickly and reduce time to translate the finical statement. Harmonization accounting standard means countries that adopt IFRS they have to prepare uniform financial statement according (IFRS) to satisfy the multinational nature of their investor base. Recently, IFRS lack of comparability across EU countries because they have different social, legal, political, cultural and economic (Bolt-Lee & Smith, 2009).

3. Current Issues in Adopting IFRS for EU

Accounting standards are crucial standard to advise and serve parties that adopt it. Harmonization of accounting standard is not just important for accounting firms but also important for shareholders, and creditors. It’s clear that convergence reduce the main differences in International financial reporting standards between nations. In fact, reducing differences in the financial reporting help companies to compare and interpret financial statement and it also helps the users of financial statement. Similarly, the convergence accounting standard has a significant effect on promoting reliability, comparability, consistency and quality financial reporting without having culture and political effect. Additionally, investors do not need to spend money to translate their financial statement in the forging countries. For example, if an Italian company operates or invest in German, it does not need to translate the financial reporting in the forging country because they have the some standard (Schipper, 2005). Recently, FRS lack of comparability across countries because they have different social, legal, political, cultural and economical. One of the main reasons that makes a great impact on reducing comparability within the EU is culture variance. Most of the researchers show that the UE need to make minimizing the level of creative accounting requests in the financial reporting process rather that convergence of standards (Ebimobowei, 2012). Besides, some members of the EU have a better position in convergence IFRS than others.

4. The Necessity of Comply IFRS as a Single Accounting Standards for UE

The EU has many large multinationals that operate all over the world; examples are Nestle, L'Oreal, Louis Vuitton Moet Hennessy etc. While having subsidiaries and operations all over EU, there is a necessity to comply with a single set of standards, which has many benefits. For instance, it will make it easier to acquire other overseas companies because there is the similarity in the financial statements. It would also be a benefit in terms of access to foreign funds and capital whereby the financial statements will be standardized and therefore easier for the monetary funds, banks, and investors to supply capital. Having mentioned this, it is for example easier for Nestle to list on the London Stock Exchange rather than the local stock exchange in terms of the similarities in financial statements. (Porter & Norton, 2013)In order to determine the pitfalls of the convergence for the EU is to rely on research through the various countries. According to Hermann and Thomas, the level of convergence is different in terms of valuing fixed assets; depreciation, R&D, goodwill and foreign currency translation of revenues are different done in the participating countries of the EU. The pressure to harmonize with the accounting standards comes from the majority of the investor groups, MNC's who use these financial statements, and this may be done in a developed country such as Germany but due to the lack of resources for the development and acceptance of these standards it becomes difficult for a less developed country like Greece to adopt these (Shahrokh, 2009).

Taking a look at the accounting practices in Cyprus for example, there is a lot of disclosure due to the many private firms and organizations that hold money from rich overseas investors and they don't pay any taxes. Looking at the Fourth Directive that has been set as valuing something 'true and fair', which is not a clearly stated directive. For Germany true and fair has a different meaning than for Cyprus. To highlight this, the European Sovereign Crisis happened when Greece wasn't able to raise a fiscal budget to raise its GDP and its exports. Since the government is corrupted, many of the companies were corrupted and did disclose many of the expenses in their books. This might of seemed true and fair to Greece (United Nations, 2007). These directives are prescriptive but are not exactly complete and they lack certain technicalities. It becomes highly difficult to set certain rules in terms of leasing, tax policies and foreign exchange transactions. The accounting guidelines need constant improvement and updates and have to somehow be able to fit everyone but there is no shoe that fits everyone. There should be also a consideration for the time period that it takes for a country to adapt certain standards, train the accountants, be able to collect information of which companies have implemented the guidelines and which countries have not. At the present time, 28 countries in the European Union adopted according to the IFRS. In order to simplify IFRS for nations, the European commission had translated IFRS for them. However, the language of EU is different and includes 23 official languages, and new language translation versions are available for members to present their financial reporting instead of in one single language (Bruggemann et al., 2013). Since the year 2000, EU has been trying to harmonize and move towards the IAS Regulation approach and the Accounting Directives approach. The IAS is focused on the public traded companies who need to prepare their financial statements according to the IFRS Standards and these statements are then reviewed by a member of state who decided to what limit the harmonization with IFRS is permitted. The accounting directives approach uses the fair value principle whereby it is allowed to make use of the local national GAAP practices to prepare the financial statements. For example, to prepare the tax liabilities and distribution of the profits, these are prepared according to the national GAAP rather than following the IFRS. (Institute of Chartered Accountants in England and Wales 2007, 2007)

5. Does the IFRS Promote Reliability, Comparability, Consistency and Quality?

The IFRS promotes reliability, comparability, consistency and quality without taking into consideration the many macro environmental factors playing a role in most of the EU counties and even between the companies themselves in terms of their industries, their size and their operations. For example, disclosure procedures are done differently between companies. Looking at the disclosure of earnings per share, which most of the public traded multinationals rely on, the company L'Oreal for example discloses their net profit before the depreciation, capital gains and capital losses and non-current asset disposals. In comparison, Kazakhmys, a UK based company specializing in petroleum and mining operations discloses the earning per share whereby they exclude goodwill and losses on property. EMI in the UK don't show the amortization of copyrights and goodwill. (Institute of Chartered Accountants in England and Wales 2007, 2007) The result of these disclosure practices is that there are many differences between the companies within one country, so it is difficult to have one size fits all standards for all the companies and for all the countries operating in the EU. Another argument for why the IFRS is not effective is because many companies evaluate their property, plant and equipment differently. There are two types of evaluation methods, which are the cost or revaluation model and the fair value model. The difference is that the cost model uses the cost less the depreciation and it is written down while the fair value uses subsequent depreciation to write down. In the UK alone, companies such as Prudential, Royal Bank of Scotland and Lloyds TSB are using the fair value method while Tesco, Fuller and Cobham are following the cost based approach. There are different methods in one country alone between the different countries, hence IFRS wants all the companies and all the EU countries to follow the guidelines which is nearly impossible. In addition, there are many directives and guidelines that have exceptions for banks to perform hedging and for certain companies who are exempted from certain obligations, such as LVMH because they have a portfolio of over 300 companies. (Institute of Chartered Accountants in England and Wales 2007, 2007) The achievement of market efficiency and high quality accounting system is related to the capacity of providing uniformed, detailed, timely information about companies simplifying the investors' evaluation and comparison of various investment opportunities (Guggiola, 2010). High quality information influences the capacity of investor of analyzing the earning management and earnings predictability.

Earnings management is a manipulation of company's earnings through addition or deduction of cash from reserves, which misleads stakeholders and influences contractual outcomes (Callao & Jarne, 2010). The effective enforcement of IFRS is minimize cases of earnings management due to reduction of alternative accounting treatments and increased stakeholders' capacity of controlling financial statements (Barth et al., 2008). The capacity of analysts to predict the earnings is more accurate when the financial reporting provides reliable and useful information (Guggiola, 2010*)*. The use of IFRS increased the accuracy of earnings prediction for different reasons. First, IFRS comparing with local standards reduced the variability of accounting factors measurements through a reduced pool of unique and comparable options available among companies (Hodgdon et al., 2008). Second, the adoption of IFRS increased the amount of public information available for all investors and reduced private information that are accessible only for an exclusive part of them (Djatej et al., 2009). Finally, homogeneous accounting standards lowered analysts errors across countries and the learning costs that they sustain analyzing different financial statements (Ashbaugh & Pincus 2001). Therefore, the adoption of IFRS increased the financial market efficiency though a reduction of costs; increased investors' trust and correct financial information However, since 2005 the harmonization process has not proceeded as planned due to the persistent use of local standards (GAAP) which reduce the effectiveness of the EU. The tradition, legal system and culture of countries have influenced the implementation process leading towards a partial rather than extensive adoption of IFRS (Guggiola, 2010). The current scenario, highlights three groups of countries with different IFRS' implementation approaches (Guggiola, 2010). First, countries such as Spain, France, Sweden, Belgium and UK have opted for a gradual compliance of local standards to IFRS. Second, countries such as Italy, Finland, Greece,

Denmark, Ireland, Luxembourg, Netherlands and most of the communist countries such as Bulgaria Czech Republic, Estonia and Lithuania have opted for an extensive implementation of IFRS. Finally, Germany, Poland, Romania, Hungary, Austria and Portugal, have still two coexisting account systems where IFRS are required for listed company and local standards for individual accounts. Even though in Germany the use of IFRS started in 1998, the government is still reluctant to adopt international standards for individual entities. Differently, since 2005 France has started a gradual convergence of local standards towards IFRS and Italy has opted for an extensive adoption (Delvaille et al., 2005; Haller & Eierle, 2004). This lack of uniformities among countries has led toward increasing compliance costs and scarce ability of comparing companies' performances (Guggiola, 2010). The implementation of IFRS involves two major issues such as the impact of different taxation systems on accounting figurers and translation problems (Oliveras & Puig, 2007). The connection between fiscal and financial rules leads European continental countries towards a partial adoption of the IFRS. Contrarily, in the Anglo-Saxon fiscal and financial rules are independent from each other, therefore, they opted for an extensive adoption (Oliveras & Puig, 2007). The use of IFRS for fiscal purpose impacts the harmonization process reducing the probability of a faster full convergence for two reasons. First, the calculation of a corporate tax considering IFRS principles leads to drawbacks due to the standardization of principles and the lack of detailed norms to determine taxable profits (Guggiola, 2010). Second, the adoption of IFRS to identify the tax base would not lead to a reduction of tax burden among countries due to differences in existing tax rates and tax incidence among countries (Guggiola, 2010). The translation of principles is another concern for the majority members of the EU. The major characteristic of accounting terminology is that certain accounting terms refer to abstract concepts, which complicate the translation process (Macintosh et al., 2000). In fact the translation process may change or lose the meaning of the original text due to the lack of similar concepts and expression of the target language (Evans, 2004).

The presence of different accounting systems, the impact of different taxation systems and language barriers increase compliance costs and complicate the comparison of listed and non-listed companies performance across countries. In addition, the different approaches embraced by countries in EU highlights a strong cultural and legal system diversity among countries, which reduces the decisional power and the effectiveness of the European Union.

6. Conclusion

In conclusion, the IFRS Board has good intentions to form a standard way to prepare and execute financial statements in the European Union because that is what EU needs since they are considered to be one single entity. However, research and arguments have proven to be against the IFRS standards mainly because there is a lot of misperception in terms of these guidelines. Countries have their differences in terms of culture, language, values and perception in doing business. Let alone the countries having differences in financial statements; companies in one country have shown to perform on different levels and therefore they have dissimilar financial statements. Since the IFRS standards take time to adapt to and because there are so many exceptions and exceptions, many companies still use their local accounting standards as guidelines and thus it creates difficulties for all the countries of the EU to simultaneously move to IFRS. There is uncertainty about the directives since they can be perceived in various ways and there is no one size fits all standard that can lead EU to conform at the same time. It would be certainly easier for EU to fully comply but in the globalized world today many companies differ in terms of size, their uniqueness, their culture and the way they do business. These characteristics outweigh the standardized approach and that is why it is not effective to implement the IFRS standards to the EU as a whole.

References:

Ashbaugh, H., (2001). Non U.S. firms' accounting standard choices. *Journal of Accounting and Public Policy*, 20, 129–153

Ashbaugh, H., Pincus, M., (2001). Domestic accounting standards, international accounting standards, and the predictability of earnings. *Journal of Accounting Research*, 39 (3), 417–43

Adibah Wan Ismail, W., Anuar Kamarudin, K., Van Zijl, T., & Dunstan, K. (2013). Earnings quality and the adoption of IFRS-based accounting standards: Evidence from an emerging market. *Asian Review of Accounting*, 21(1), 53-73.

Barth, M. E., Landsman, W. R. and Lang, M. H., (2008). International accounting standards and accounting quality. *Journal of Accounting Research*, 46, 467-498.

Bolt-Lee, C. & Smith, L. M. (2009). Highlights of IFRS research. *Journal of Accountancy*, 208, 48.

Bruggemann, U., Hitz, J.-M. & Sellhorn, T. (2013). Intended and unintended consequences of mandatory IFRS adoption: A review of extant evidence and suggestions for future research. *European Accounting Review*, 22, 1-37.

Carmichael, D., & Lynford, G. (2012). *Accountants' Handbook, Financial Accounting and General Topics*. Hoboken, New Jersey, Canada: John Wiley& Sons.

Callao, S., Ferrer, C., Jarne, J. I., & Lainez, J. A. (2009). The impact of IFRS on the European Union: Is it related to the accounting tradition of the countries?. *Journal of Applied Accounting Research*, 10(1), 33-55.

Delvaille, P., Ebbers, G., Saccon, C., (2005). International Financial Reporting Convergence: Evidence from three Continental European Countries. *Accounting in Europe*, 2 (1), 137–164

Djatej, A., Gao, G., Sarikas, R.., & Senteney, D., (2009). An investigation of the comparative impact of degree of implementation of IFRS upon the public and private information quality of East and West European firms. *Advances in Accounting, incorporating Advances in International Accounting*, 25, 208–215.

Ebimobowei, A. (2012). Convergence of Accounting Standards: The Continuing Debate. *Asian Journal of Business Management*, 4, 159-165.

Evans, L. (2004). Language, translation and the problem of international accounting communication. *Accounting, Auditing and Accountability Journal*,17, 210-248.

Epstein, B. J., & Jermakowicz, E. K. (2008). Wiley IFRS 2008: Interpretation and Application of International Accounting and Financial Reporting Standards, John Wiley & Sons.

Guggiola G., (2010). IFRS Adoption in the E.U., *Accounting Harmonization and Market Efficiency: A Review.* Varese: University of Insubria Press.

Haller, A., Eierle, B., (2004). The adaptation of German accounting rules to IFRS: A legislative balancing act. *Accounting in Europe* 1 (1), 27–50.

Hodgdon, C., Tondkar, R., Harless, D., Adhikari, A., (2008). Compliance with IFRS disclosure requirements and individual analysts' forecast errors. *Journal of International Accounting, Auditing and Taxation*, 17, 1–13.

IFRS Foundation. (2014 r). IFRS Foundation and IASB: Who We Are and What We Do. Retrieved on 4 October 2014 r., from IFRS Foundation: http://www.ifrs.org/About-us/Pages/Who-We-Are.aspx

Institute of Chartered Accountants in England and Wales. (2007). EU Implementation of IFRS and the Fair Value Directive. London: Institute of Chartered Accountants in England and Wales 2007.

Kaserer, C., & Klingler, C. (2008). The accrual anomaly under different accounting standards–lessons learned from the German experiment. *Journal of Business Finance & Accounting*, 35(7-8), 837-859.

Macintosh, N., T. Shearer, D. Thornton & M. Welker. (2000). Accounting as Simulacrum and Hyperreality: Perspectives on Income and Capital. *Accounting, Organizations and Society,* 25, 13-50.

Porter, G., & Norton, C. (2013). *Using Financial Accounting Information: The Alternative to Debits and Credits*. Stamford, USA: Cengage Learning.

Narktabtee, K., & Patpanichchot, S. (2011). The impact of country-level vs firm-level factors on the effectiveness of IFRS Adoption: The Case Of European Union. *International Business & Economics Research Journal (IBER)*, 10(10), 79-92. doi:http://dx.doi.org/10.19030/iber.v10i10.5985

Oliveras, E., Puig, X., (2007). The Changing Relationship between Tax and Financial Reporting in Spain. *Accounting in Europe*, 2(1), 195–207.

Schipper, K. (2005). The introduction of International Accounting Standards in Europe: Implications for international convergence. *European Accounting Review*, 14, 101-126.

Shahrokh, M. S. (2009). *International Accounting: A User Perspective*. Chicago: CCH.

United Nations. (2007). International Accounting and Reporting Issues: 2007 Review. Geneva, Switzerland: UNCTAD.