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On the global acceptance of IAS/IFRS accounting standards: The logic and implications of the principles-based system[☆]

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ABSTRACT

The widespread acceptance of International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) makes it timely to examine their technical determinants as well as their implications for the accounting profession and the process of accounting harmonization. In this respect, we suggest that the principles-based approach to the standards and its inner flexibility enables the application of IAS/IFRS to countries with diverse accounting traditions and varying institutional conditions. Furthermore, the principles-based approach involves major changes in the expertise held by accountants and, hence, in their educational background, training programs, and in the organizational and business models of accounting firms. Finally, we submit that the standards set by the IAS/IFRS constitute a step forward in the process of accounting harmonization, although there is still far to go in the comparability of accounting measures across countries and regions.

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1. Introduction

The harmonization of accounting standards has made considerable progress within a relatively short period of time (Camfferman and Zeff, 2006). In 1993, Daimler Benz AG aimed to list on the New York Stock Exchange (NYSE); hence, it needed to reconcile its financial statements to comply with US Generally Accepted Accounting Principles (US GAAP). Under German GAAP, the firm had reported a net income of 615 million Deutschmarks (DM) for the 1992 year, which turned into a net loss

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of DM1, 839 million under US GAAP (see also Ball (2004)). On November 15, 2007, the US Securities and Exchange Commission (SEC) allowed the operation of foreign private firms using International Financial Reporting Standards¹ on the NYSE without first reconciling their financial statements to US GAAP. The financial press enthusiastically greeted this move; on November 19, 2007, the *Financial Times* wrote: “The goal of a single worldwide accounting language has long been a dream. Today it is fast becoming a reality—and the pace is picking up.”

A number of forces have driven acceptance towards a common set of accounting standards. Processes of political integration, exemplified by the European Union, as well as the globalization of financial markets and firms' operations in different jurisdictions are among the driving forces (Flower, 2004a,b; see also Ball (2006)). In the global arena, the stock of foreign direct investment increased from US\$1.7 trillion in 1990 to US\$6.6 trillion in 2001 (UNCTAD, 2002). Nevertheless, these forces do not suffice in explaining how accounting standards have gained widespread acceptance. Arguably, harmonized accounting standards need to meet some technical features to enable acceptance by countries with diverse cultures and reporting traditions. In the current article, we examine the logic of IAS/IFRS that facilitated its widespread acceptance and adoption in more than 100 countries, as well as the implications of these standards for the accounting and auditing professions. Furthermore, we discuss the extent to which the adoption of IAS/IFRS accounting standards have driven convergence and, hence, removed substantial reporting and measurement differences across countries.

2. Principles-based vs. rules-based systems

A distinctive feature of the IAS/IFRS standards is that they are “principles-based” instead of “rules-based”. As noted by Nelson (2003, p. 91), “...rules include specific criteria, ‘bright line’ thresholds, examples, scope restrictions, exceptions, subsequent precedents, implementation guidance, etc.” In contrast, “principles-based” standards refer to fundamental understandings that inform transactions and economic events. Under a principles-based system, these understandings dominate any other rule established in the standard. In the case of consolidation, for example, IAS 27 states that full consolidation should be enforced whenever a firm exerts “control” over another firm. As a governing measure of consolidation, the “principles-based” notion of control, IAS 27, par. 4, states: “...the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities”. In turn, this superimposes any specific rule, such as the percentage of voting rights owned by the controlling company vis-à-vis the controlled firm. If a firm actually exerts control over another company, the “principles-based” system establishes that full consolidation should be undertaken, no matter how such control is executed (e.g., board interlocks).

Principles-based systems thus issue generic accounting standards. As opposed to rules-based systems, accounting standards of the *principles* persuasion do not address every controversial issue at hand but keep considerable ambiguity about such major processes as record keeping and measurement. The broad nature of IAS/IFRS, for example, explains why they do not adopt a position with respect to accounting for sales incentives. Consequently, IAS/IFRS leaves it up to firms to make any accounting choice that does not contravene the principles established in the standards; the accounting choices regarding the recognition of actuarial gains and losses provide a useful example in this regard. According to IAS 19 *Employee Benefits*, the adoption of the corridor approach can smooth actuarial gains and losses; the results affect net income for the part that exceeds the “corridor” of plus or minus 10% of the maximum between the Projected Benefit Obligation and the Fair Value of the assets of the plan. Alternatively, the income statement can directly recognize the gains and losses. As a third choice, actuarial gains and losses can be recognized fully and immediately into equity and, hence, without affecting the income statement. The IAS 16 *Property, Plant and Equipment* equally enable different accounting choices such as the cost method and the revaluation method for the accounting of tangible assets.

¹ The International Accounting Standards Board (IASB) issues International Financial Reporting Standards (IFRS). During the period 1973–2000, the International Accounting Standards Committee (IASC), the predecessor to the IASB, issued these as International Accounting Standards (IAS). Importantly, the IASB recognizes standards issued by the IASC.

The IAS/IFRS standards have gained global acceptance and implementation. Countries using rules-based systems (e.g., Germany) as well as those employing principles-based systems (e.g., the United Kingdom) apply IAS/IFRS standards. At the same time, common law countries (e.g., Australia and New Zealand) and those with a civil-law tradition (e.g., Italy and Spain) also implement these standards. Moreover, countries with diverse national cultures equally apply the standards set by the IAS/IFRS (Ding et al., 2005). This global acceptance of IAS/IFRS, we argue, largely rests on its principles-based nature as well as on its driving notions of openness and flexibility. These ideas are instrumental in accommodating diverse institutional settings and traditions under a common set of standards. However, in principles-based systems rules are necessary to provide the principles with a structure (Benston et al., 2006b).

Analytical research also provides some interesting insights into the debate on strict (rules-based) vs. flexible (principles-based) regulatory regimes (Dye and Sridhar, 2004). From an analytical point of view, the superiority of stricter regimes is hardly unequivocal. Trombetta (2001) shows that settings exist where stricter regimes perform worse than their more flexible counterparts do. Intuitively, a strict regulatory regime imposes uniformity of treatment on a variety of firms operating under quite different circumstances. This uniformity involves an informational cost because it reduces the amount of information that the observation of different accounting policy choices can extract. Investors can then learn about a firm from their observations of the company's choices on issues such as the treatment of actuarial gains and losses of a pension plan under IAS 19.

The implementation of IAS/IFRS across countries and regions has some additional implications. In the current paper, we comment on the effect on the accounting and auditing professions. Furthermore, we discuss the extent to which the application of IAS/IFRS in different jurisdictions results in financial statements with uniform properties. In turn, we embed this discussion in the steady trend towards business globalization, an issue that affects both auditors and their clients.

3. The accounting and auditing professions under IAS/IFRS

Under a rules-based system, accountants obtain access to detailed implementation guidance. Arguably, specific rules considerably reduce uncertainty from the accountant's role, which ultimately results in a mechanical application of the specific rules established in the standards. To some extent, the commonly held view of the accounting profession as "dull" has its roots in these mechanical understandings of the accounting process. In countries with a rules-based accounting system, the adoption of the IAS/IFRS standards brings about a different mindset that sharply contrasts with the prior national, regulatory setting. In particular, the principles-based nature of IAS/IFRS standards and the related notions of openness and flexibility exert a lasting effect on the educational background and professional skills of accountants and auditors.

The adoption of IAS/IFRS requires accountants to possess a solid knowledge of business and economics. In this respect, accountants should grasp a comprehensive understanding of the business and economic fundamentals of transactions and events before deciding on its accounting treatment. The case of the investment made by Pirelli in Telecom Italia helps to illustrate this point. In 2001, Pirelli subscribed to 60% of a firm called Olimpia. At the same time, Olimpia had bought 27% of Olivetti, which in turn owned 55% of Telecom Italia. A mechanistic application of the 20–50% "rule" would state that Pirelli should fully consolidate Olimpia. According to this reasoning, Olimpia was required to report the investment in Olivetti under the equity method whilst Olivetti needed to consolidate Telecom Italia fully. Nonetheless, a close inspection of Pirelli Consolidated accounts for the year 2001 revealed that the Chairman of Pirelli at the time was also the Chairman of Olimpia, the Deputy Chairman and Managing Director of Olivetti and the Chairman of Telecom Italia. Moreover, the Deputy Chairman of Olimpia was also the Deputy Chairman of Olivetti and the Deputy Chairman of Telecom Italia. With this information in hand, can we still defend why we should not fully consolidate Telecom Italia's financial statements into Pirelli's accounts? A principles-based approach would draw on the notion of control as the dominating principle. This is the notion adopted in IAS 27, which would consider Telecom Italia as a subsidiary of Pirelli and consequently would call for full consolidation. However, the only way to reach this conclusion and correctly apply IAS 27 is by conducting a thorough

examination of the economics and business essence of the relationships between Pirelli, Olimpia, Olivetti and Telecom Italia. As noted, the mere reliance on the percentage of shareholding does not bring about such a conclusion.

Principles-based systems feature professional judgment as a distinctive element of the accounting process (Schipper, 2003). Under these systems, accountants are required to make a considerable number of estimates for which they are responsible. In addition to technical skills, the accountant's role involves some ethical and legal implications that are barely discernible under a rules-based system. In turn, these changes affect the role of auditors, who should not merely report formal compliance of a firm's financial statements with a set of rules. Under a principles-based system, auditors need to grasp a proper understanding of the extent to which a firm properly applies the standards set by the IAS/IFRS. This understanding, we contend, requires an informed judgment about the business and financial situation of the firm. In some countries, this will ultimately involve substantial changes in the training and educational programs of accountants and auditors, especially in those jurisdictions where there is no accounting profession and/or auditing is perceived as an "activity" and thereby lacks professional status (e.g., Spain; see Carrera et al. (2008)).

Moreover, the worldwide introduction of IAS/IFRS creates important implications for the market for audit services. One of the reasons used to explain the progressive concentration in this market is that only large audit firms can provide international corporations with the expertise needed to consolidate accounts produced under many different sets of national standards. Paradoxically, the harmonization of accounting standards worldwide through IAS/IFRS could have important effects on the market prospects of second-tier accounting firms. This is a direct consequence of the complexity of the reconciliation process from a subsidiary's home standards to the parent's home standards. This harmonization process will also put to test the true "global" nature of the Big-4 audit firms. The communication between national partners and global teams in Big-4 audit firms will then probably strengthen the organizational links between local practices and international headquarters.

4. Accounting harmonization and IAS/IFRS

The principles-based system featured by IAS/IFRS has been instrumental in the global acceptance of the accounting standards. However, the extent to which the application of IAS/IFRS enhances the international convergence of accounting practices remains outstanding. In this respect, empirical research has distinguished between the voluntary adoption of IAS/IFRS within the European Union before 2005 and their mandatory adoption after 2005.

Research examining voluntary adoption is mounting (see Soderstrom and Sun (2007) for an excellent review). Accordingly, we focus on those studies that are particularly significant for the purposes of this paper. In this respect, Daske et al. (2007a) distinguished between firms that voluntarily applied IAS/IFRS into *serious* and *label* adopters. The distinction captured the idea that some adopters seriously modify their financial reporting strategy after adoption (*serious*), whereas others use the flexibility of IAS/IFRS standards to keep on using their usual financial reporting strategy under the new international label (*label*). Daske et al. (2007a) find that the positive effects of adoption are more pronounced for serious adopters than label adopters. When the two groups of adopters are pooled together, the average effects of adoption become modest. In a related vein, Barth et al. (2008) investigated the effects of voluntary adoption of IAS/IFRS on various measures of accounting quality. They found that adoption significantly improved accounting quality by reducing earnings management and enhanced both the value relevance of accounting numbers and the timeliness of loss recognition. In spite of this, they also suggested that the results could be partly attributed to differences in firms' incentives, as well as the varying economic environments of the sample firms.

Research addressing the mandatory adoption of IAS/IFRS within the European Union after 2005 is at an early stage, given that it is a relatively recent phenomenon. Daske et al. (2007b) examined the economic consequences of mandatory IAS/IFRS adoption in a large sample of firms established in 26 different countries. Although adoption did not have seemingly strong effects, the consequences were particularly notable, especially in jurisdictions whose domestic GAAP differed from IAS/IFRS standards. Finally, Christensen et al. (2008) investigated the unique institutional setting provided

by Germany where firms could voluntarily adopt IAS/IFRS before 2005. This enabled the isolation of the incentive effect and its comparison with the mandating of adoption for companies that obviously did not have an incentive to do so voluntarily. In this setting, Christensen et al. (2008) compared the effects of voluntary vs. mandatory adoption. They found that the economic effects of adoption were significant for voluntary adopters but insignificant for forced adopters. These findings question the assumption that mandatory enforcement of IAS/IFRS will result in improvements in accounting quality.

In sum, extant research suggests that financial reporting practices do not necessarily change after mandatory adoption; firms may adopt the “label” of IAS/IFRS and then use its flexibility to retain existing accounting policies. Consequently, uniformity of accounting treatments is not an automatic outcome of the mandatory adoption of IAS/IFRS. Further, empirical evidence suggests that accounting quality significantly improves in cases of voluntary adoption but does not necessarily improve after mandatory adoption.

5. Discussion and conclusion

The widespread acceptance of IAS/IFRS requires examination of its technical underpinnings as well as examination of its implications for the accounting profession and the process of accounting harmonization at large. In this respect, we argue that the inner flexibility of the principles-based approach enables the application of IAS/IFRS in countries with diverse accounting and institutional environments. Moreover, the principles-based approach brings about a number of fundamental changes in the backgrounds and skills of accountants and auditors. Notwithstanding our contention that the IAS/IFRS standards constitute a step forward in the process of accounting harmonization, there is still a long way to go in the comparability of accounting measures across countries and regions.

The IAS/IFRS rely on a principles-based system to set accounting standards. This system, in turn, provides flexibility to render possible the global acceptance of the standards. As noted by some commentators, principles-based accounting standards constitute “the solution” to the problem of accounting harmonization.² In this respect, we suggest that the adoption of a flexible approach by the IASB constitutes a feasible move towards accounting harmonization. Indeed, this approach has enabled more than 100 countries to apply IAS/IFRS standards within a relatively short period. In view of the dramatic reconciliation of firm financial statements performed up until quite recently, we could regard this as a new accounting revolution (see Beaver, 1989). In this respect, we focus our discussion on the implications of these changes for fraud deterrence as well as on the differences between domestic standards and IAS/IFRS.

The inherent flexibility in the principles-based approach could also act as a more effective fraud deterrent. In this respect, empirical research suggests that firms voluntarily adopting IAS/IFRS enhance accounting quality, as well as the relevance of accounting numbers, and reduce earnings management (Barth et al., 2008). As shown by recent accounting scandals and financial crises, the regulator can hardly anticipate the distinctive features of the evolution of global business. Furthermore, the highly prescriptive nature of some national standards (e.g., the US) does not provide the best context for the accounting and audit professions to play an active role in detecting and denouncing these potentially disrupting situations (Baker and Hayes, 2005). In this respect, former SEC Chairman Roderick Hills (2003), has argued:

The fact is that accountants are becoming or have become rule checkers, applying the myriad of FASB pronouncements and clarifications rather than using their judgment as to what is a fair presentation of financial statements. The fact is at far too many CEOs regard the annual audit as a commodity required by government rather than an exercise that has intrinsic value.

Under a principles-based system, auditors are responsible for providing judgment over the implementation of a broad set of accounting standards rather than following the specific guidance stated in a rules-based system. This approach will have effects on the auditing profession because of the

² Benston et al. (2006a, 79) share this position, though qualified in light of their discussion of the asset/liability and revenue/expense approaches.

possible increase in audit and litigation risks. As pointed out by Healy and Palepu (2003), it could also stimulate the creation of a new business model for auditors. According to Healy and Palepu (2003), auditors will now offer a new type of service where the audit report is a complete and argued opinion about the faithfulness of the financial statements to the intrinsic reality of the activities performed by the company during the year.

The adoption of principles-based IAS/IFRS standards may also bring about organizational consequences for accounting firms. Traditionally, firms keep separate the accounting division from the operations division as well as from the public relations/communication divisions. In a “rule checking” approach, the accountant does not require a deep understanding of the economic and business underpinnings of the firm’s financial statements. Conversely, under IAS/IFRS “compliance with the rule” is no longer the case. Consequently, we would expect improvements in the relationships between the operations and financial reporting divisions of accounting firms. Moreover, accounting choices should be effectively communicated to stakeholders and this process requires close cooperation between the accounting and public relations divisions of professional services firms. Anecdotal evidence gathered from our own conversations with practitioners and consultants makes us believe that this is a fundamental challenge posed by the widespread adoption of IAS/IFRS. The rigorous study of these organizational implications is worthy of future academic research.

The harmonization process will also benefit from the “global” nature of both auditors and their clients. Arguably, auditors and clients will drive forward common interpretations and practices around the world. Global clients willing to reduce the steps needed to unify the accounting information produced by local subsidiaries will promote this process. Consequently, global auditors may push forward harmonization through consistent interpretation to accommodate the needs of global clients. In this manner, auditors will also be facilitating the global character of business. In turn, the number of global clients in favor of globally harmonized interpretations will arguably increase and this will enhance the comparability of financial statements across countries.

The differences between IAS/IFRS and domestic standards may be attributed to the reconfiguration of power among standard setting bodies. This situation largely resembles those recurrently featured in the process of transnational integration, where national representatives “...retain the ultimate legal claim to effective supremacy over what occurs within their own territories” (Held, 2005, p. 242). In this case, it is not so much a matter of accepting the IAS/IFRS standards, but the rules and norms set by a peer institution established in a different country. Differences between domestic accounting standards and IAS/IFRS can be explained by absence and divergence (Ding et al., 2007). Absence is the extent to which the rules regarding certain accounting issues are missing in domestic accounting standards but covered in IAS/IFRS. Divergence applies in circumstances where the rules regarding the same accounting issue differ in domestic accounting standards and IAS/IFRS. Ding et al. (2007) found that absence is mainly determined by the importance of the equity market and market concentration, whereas they found a positive association between divergence and the level of economic development and the importance of the accounting profession. At the same time, divergence is constrained by the importance of the equity market. Under these circumstances, Ding et al. (2007) suggest that emerging countries often treat IAS/IFRS as a reference point and a means to upgrade their own accounting system.

Emerging economies, though, aim to play an active role in the convergence process (Ezzamel and Xiao, 2007). In the case of China, this results in the perception of convergence between Chinese GAAP and IAS/IFRS as a two-way process where each one of the two parties has the right to try and influence the direction of accounting harmonization (Ezzamel et al., 2007). More generally, the adoption of IAS/IFRS by countries with institutional contexts different from those experienced by their Anglo-Saxon counterparts along the flexibility of the principles-based approach may affect the standard setting process in ways that are difficult to predict at the moment. For example, emerging economies lack well developed markets and this makes it difficult to implement the market based approach to the estimation of fair values, a concept that may involve controversial meanings within institutional contexts that are remarkably different from those that witnessed the emergence of this notion. Therefore, these countries will likely develop and propose alternatives for this estimation. In this respect, we submit that examination of the implementation of IAS/IFRS in emerging countries might be a potentially relevant research area for scholars interested in international accounting and public policy.

In sum, we have addressed the principles-based notion underlying IAS/IFRS. This notion, we argue, has enabled the worldwide application of the standards. Furthermore, compliance with the IAS/IFRS involves new understandings of the role and background of the accounting and auditing professions, from mechanistic implementation and certification of rules to decisions on the best possible accounting alternative among those enacted in the standards. In turn, this openness and flexibility poses some problems for the comparability of accounting figures and measures. At the same time, we submit that the inherent flexibility of accounting standards could act as a deterrent to fraud. At the same time, the adoption of IAS/IFRS may have consequences on the organization and business models of accounting and auditing firms. Finally, and notwithstanding our contention that the principles-based approach to accounting harmonization constituted a plausible route to international convergence, there is a long way to go in the process of cross-national comparability. In addition to problems arising in developing countries and economies in transition, empirical research addressing developed settings reveals that the flexibility of the IAS/IFRS standards may serve the purposes of *label* adoption (Daske et al., 2007a): that is, firms use flexibility to retain their traditional accounting policies.

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