

EMPIRICAL STUDY ON THE IMPACT OF CULTURE ON ACCOUNTING PRACTICES: DOES IT DISAPPEAR AFTER THE INTRODUCTION OF IFRS?

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ABSTRACT

Related to the evidence found in previous investigations of cultural influences on accounting practices, this paper tries to analyze whether cultural differences across countries can be an explanation for differences in accounting practices across countries. The goal of this paper is not to examine accounting differences prior to IFRS adoption, but rather to use evidence found in the previous research as a guidance to find cultural impacts on IFRS implementation. It aims to answer the research question: “Does culture have an influence on accounting practices especially IFRS practices?”

Theory suggests that cultural impact on accounting practices will disappear due to the standardization of accounting practices after the introduction of IFRS (Nobes and Parker, 2004; Deegan, 2009). I will try to answer the question whether the impact of culture is different in studies that incorporate IFRS in their research design as compared to studies that do not. The focus is on studies which use the Hofstede-Gray framework (1988) that relates culture and accounting values to accounting systems and practices. The accounting systems / practices are concerned with four different areas namely authority, enforcement, measurements and information disclosures.

KEY WORDS: Accounting Practices, Culture and IFRS Adoption.

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Introduction

Due to the growth of multinational companies and an increasing trend in globalization, there is a need for a single set of accounting standards that facilitates the process of exchanging, sharing and reporting financial results for international business activities. The trend towards harmonization of international accounting standards has evolved in the past three decades. Most common obstacles of harmonization process are listed by Elnathan and Krlich (1992). The three common obstacles are the differences in national accounting systems, nationalism and language differences. The first obstacle is related to the differences in the users of financial reporting and legal systems, the second obstacle is related to cultural differences and national pride and the third one is related to proper communication channels in interpretation of different terminology. Despite of these obstacles, the International Accounting Standards Board (IASB) prevails to develop a single set of high-quality reporting standards called International Financial Reporting Standards (IFRS). The publicity of IFRS is an important milestone in the harmonization process of accounting practices. Nowadays, IFRS is the basis of the financial reporting standards of most countries and encouraged improvement and convergence of accounting standards.

Several years further away since the introduction of IFRS, it seems that systematic differences in the accounting practices between countries which applied IFRS still exist (Ball, 2006; Kvaal and Nobes, 2010). It seems that even after IFRS adoption, many companies are still preserved their national accounting practices in a way that minimizes as far as possible changes in the form of financial reporting that they applied under their previous national GAAPs (Ernst&Young, 2006). There are many relevant literatures related to international differences in financial reporting prior to IFRS adoption. Few reasons of IFRS implementation differences have been suggested such as legal system, providers of finance, taxation, culture and other external factors (Nobes and Parker, 2004, ch. 2). Harrison and McKinnon (1986) list some elements of a general theoretical model, but there is no specification which factors are major explanatory variables for accounting practices. In 1988, Gray develops a model based on Hofstede's (1980) cultural / societal values related to accounting practices. In his model, he draws a link between societal values and accounting values, and how both values reinforce accounting practices in a particular country. The framework was extended by Doupnik and Salter (1995) who developed a general model of accounting development which links external environment, culture and institutional structures to

accounting practices. Culture has been established by former researchers to be one of the major reasons of differences in accounting practices (Doupnik and Salter, 1995; Nobes, 1998).

Relevance

In perspective of financial markets, high quality of financial statements contributes to lowering cost of capital since trustworthiness of an investor to financial reports appeals them to provide capital at a lower cost. Therefore countries which adopt an internationally recognized and understood accounting standard for financial statement will gain significant advantages to those who do not (Sharpe, 1998). The harmonization of financial reporting is expected to increase market efficiency by reducing monitoring costs and decreasing cost of raising capital. Some empirical studies suggest positive effects of IFRS adoption on financial markets efficiency. Daske *et al.* (2008) investigate the economic consequences of compulsory IFRS adoption around the world. Using a large sample of firms which are obligated to adopt IFRS, they found an increase in average market liquidity around the time of the IFRS introduction, a decrease in firm's cost of capital and an increase in equity valuations. Investors believe that the benefit of IFRS adoption outweighs the implementation cost. This is affirmed by an empirical study of market reaction to events surrounding the adoption of IFRS in Europe (Armstrong *et al.*, 2010). They found significant positive market reactions to events that increased the likelihood of IFRS adoption and vice versa. Another empirical study suggests strong positive abnormal returns of IFRS adoption and a substantial long-run reduction in the cost of capital (Karamanou *et al.*, 2005). From an economic point of view, early evidences indicate that the harmonization process appears to bear its fruit which is to accommodate financial markets with high quality information and improve capital market efficiency by increasing accessibility of global capital and lowering cost of capital (Guggiola, 2010). Despite of the evidence that IFRS adoption has positive economic consequences, there are still some aspects to be improved in comparability and consistency of financial statements that comply with IFRS. By focusing on one factor i.e. culture, this paper analyzes the extent of cultural impact, if there is any, on accounting practices when IFRS is incorporated in the research design. It investigates whether culture is a possible cause of international differences in the standardization of accounting practices. By understanding the underlying reason of differences in accounting practices, standard-setting bodies can take into account the societal and accounting values in the agenda of IFRS implementation. Furthermore, this paper contributes in informing users that the claim of consistent and full comparability of

financial statements under IFRS standards have not yet been accomplished and culture may be an important explanatory variable. It also reminds standard setters to take into account that inevitable cultural differences may influence the implementation of proposed accounting standards.

Research Process

The development of accounting systems in a nation does not happen in a single process. It is an evolving process wherein accounting values and institutional consequences constantly influence accounting systems (see figure 1). External influences such as foreign trade and investment have an impact on the environment / ecology of a nation. Figure 1 shows how societal values receive ecological influences and forward it to both accounting values and institutional consequences. These accounting values and institutional consequences are reflected in the accounting systems. The accounting systems reciprocally influence accounting values and ecological influences, reinforced the consequences of an accounting system. The reinforcement of accounting systems preserves the accounting practices in a nation. Consequently, the finding of national IFRS patterns (Nobes, 2006; Ernst&Young, 2006) is not surprising because accounting values are

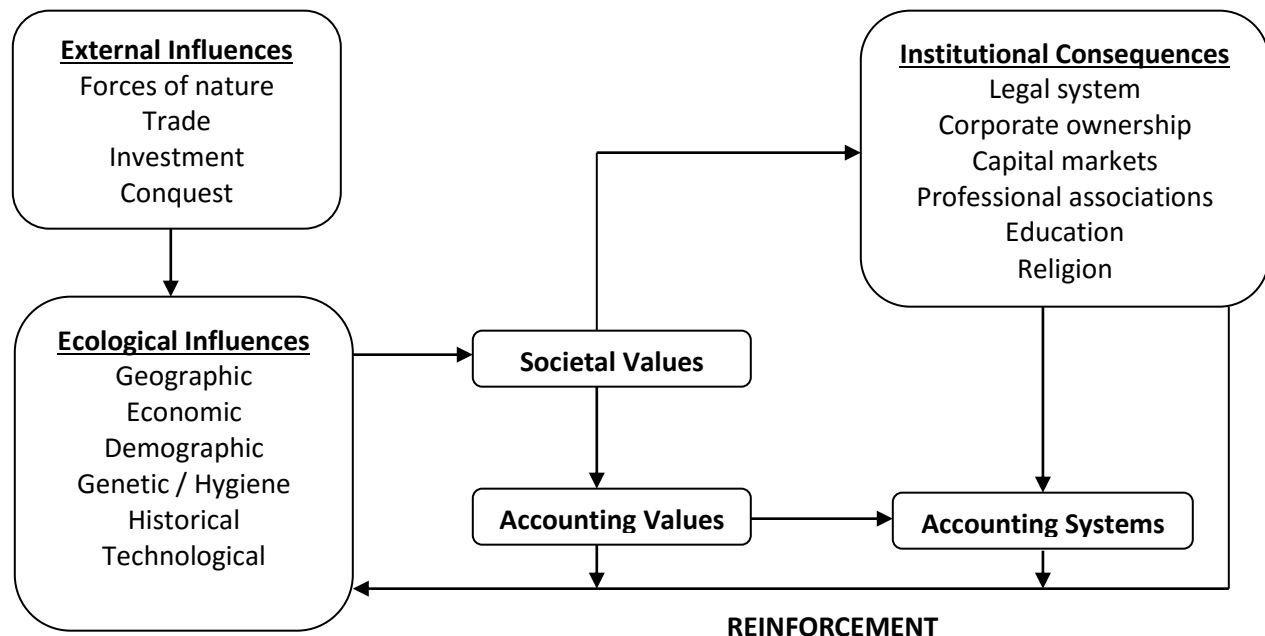


Figure 1: Gray (1988) Culture, societal values and accounting subculture

Implanted in the root of accounting practices of a country. After the introduction of a new standard, that is IFRS, accounting practices should comply with that new standard. The development of accounting systems at the sub-cultural level is related to societal values orientations, since such values pervade a nation's social system (Gray, 1988). If societal values do not change, correspondingly it is expected that accounting values also do not change. Since societal values remain unchanged and likewise accounting values, therefore IFRS practice is inevitably impacted by the culture of the related country.

Using three sub-questions which have been mentioned before, a comparison will be made between accounting practices before and after the introduction of IFRS. However, due to the absence of empirical literature about cultural influences on IFRS implementation, this kind of comparison cannot be made. Therefore we review empirical studies that incorporate accounting rules based on IAS / IFRS in their research design and discuss these studies further in the section of analysis. There are three accounting practices to be examined: authority and enforcement, measurement practices, and information disclosure. These three accounting practices are expected to be similar or converged when a uniform set of accounting standards i.e. IFRS is applied. If convergence in the accounting practices does not happen, the extent of culture as a possible explanation on this divergence will be investigated. Empirical literatures are used to identify whether influences of cultural values through accounting values of a nation appear in these three accounting practices.

Methodology

The methodology of this paper is based on literature review. This exploratory study relies on the work of former researchers and takes logical inferences based on their studies. There are two theories that will be used i.e. a theory of Hofstede (1980) on societal values and a theory of Gray (1988) that links Hofstede's societal values to accounting values and accounting systems / practices. The latter is known as the so-called Hofstede-Gray framework and our literature review studies consist of studies that make use of this framework.

Characteristics of IFRS standards

In the development of IFRS, the IASB emphasized on sound and clearly stated principles from which an interpretation is important. It is also referred to as a principle-based standard. In a

principle-based standard, there are fundamental understandings about transactions and economics events which lead any other rules established in the standard. Because it does not address every accounting issue, the implementation of a principles-based standard requires professional judgments from accountants in making estimation of certain events and transactions (Carmona *et al.*, 2008). In contrary a rule-based standard such as U.S. GAAP consists considerably more application guidance (or rules). In general, IFRS do not give clear guidelines when distinguishing among circumstances in which different accounting requirements are specified (Ankarath *et al.*, 2010). This reduces the opportunities to arranging transactions to attain particular accounting effects, as what happened at the famous accounting scandal during year 2002 in the United States. The principle-based approach reduces the length of the text of the IFRS which is about 2000 to 3000 pages in length, in contrast with U.S. GAAP which covers more than 20.000 pages of literatures (Ankarath *et al.*, 2010).

IFRS adoption

The collapsed of Enron followed by other accounting fraud cases which erupted in 2002 exposed the shortcomings of the U.S. 'rules-based' standard. The rules-based approach which is common in U.S. GAAP has been criticized, contrasting it with the principles-based standards such as IFRS. Shortly after the major accounting scandals in the United States, a Convergence Project between IASB and the U.S. accounting standards board i.e. Financial Accounting Standards Board (FASB) started which aims to narrow the differences between U.S. GAAP and IFRS. In 2007, the US Securities and Exchange Commission (SEC) allowed non-U.S. companies registered in the United States to comply with IFRS without any necessity to reconcile with U.S. GAAP. SEC also published a proposed roadmap on IFRS adoption for domestic U.S. companies. The assessment of these convergence milestones will determine whether to mandate the adoption of IFRS in the United States. The decision of the adoption was made in 2011 (see IASB website). The U.S. involvement in the harmonization of accounting standards fosters the global acceptance of IFRS given that the U.S. constitutes the world's major capital market (Deegan, 2009, p. 121). In the past few years, the international accounting standard-setting process has claimed a number of success in achieving greater recognition and the use of IFRS. Since 2001, many countries have required or permitted the use of IFRS. Table 1 shows the lists of countries which required some or all companies to apply IFRS. All remaining major economics have

established timelines to converge with or adopt IFRS in the near future. In the European Union itself, IFRS were adopted in 2005 which applies to more than 10000 companies in over 150 countries (Mirza *et al.*, 2008). This adoption noted as one of the largest financial reporting changes in the world, as it affected numerous listed firms in the European Union.

Table 1: Countries that have adopted IFRS

Africa	Botswana, Egypt, Ghana, Kenya, Malawi, Mauritius, Mozambique, Namibia, South Africa, Tanzania
Americas	Bahamas, Barbados, Brazil (2010), Canada (2010), Chile (2009), Costa Rica, Dominican Republic, Ecuador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Nicaragua, Panama, Peru, Trinidad and Tobago, Uruguay, Venezuela
Asia	Armenia, Bahrain, Bangladesh, Georgia, Hong Kong, India (2011), Israel, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Lebanon, Nepal, Oman, Philippines, Qatar, Singapore, South Korea (2011), Tajikistan, United Arab Emirates.
Europe	Austria, Belarus, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Macedonia, Malta, Montenegro, Netherlands, Norway, Poland, Portugal, Romania, Russia, Russia, Serbia, Slovakia, Slovenia, Spain, Sweden, Turkey, Ukraine, United Kingdom.
Oceania	Australia, Fiji, New Zealand, Papua New Guinea

Source: Wiley IFRS: practical implementation guide and workbook. John Wiley & Sons Inc. (Mirza *et al.*, 2008).

Note: After a long time of trading under Economic Sanctions from international community Iran is rolling back to enforce the use of IFRS since some of the companies have started to implement IFRS.

Iran eyes IFRS adoption by 2016

Iranian listed companies, approximately 500, will have to prepare their financial statements under IFRS from 2016 onwards, local practitioners told The Accountant.

A circular from the Tehran Stock exchange, states that listed companies should comply with the international standards from the Iranian year 1395, which is financial year 2016 according to the Gregorian calendar.

Abbas Vafadar, who is the managing partner of Iranian audit firm Azmoon Pardaz, said the profession in Iran has pushed hard for the adoption of IFRS during the last years. Saeed Jamshidi Fard, chairman of a national investment firm and an accountant member of one of the national professional bodies, said at the moment some listed companies use IFRS on a voluntary basis, with certain amendments to adapt to the local market. The move is expected to increase the demand for IFRS training in the country. The ACCA head of Northern Gulf Anis Motorwala said that's a positive indicator for IFRS-based qualifications.

Relationships of Culture and Accounting

The impact of culture on financial accounting has become an increasing interest to accounting researchers. The relevance of culture on accounting practices has been a long debate particularly in the field of international accounting (Burchell et al., 1980 and Meyer, 1986). Previous research has shown the existence of different patterns in accounting systems internationally. One of the reasons is the environmental factors which tend to have great impact on the development of national systems. Many researchers have tried to identify and establish the environmental factors involved (Radebaugh, 1975; Nair and Frank, 1980; Nobes, 1983; Douppnik and Salter, 1993). This section gives an overview of international accounting research associated with culture prior to the Hofstede-Gray framework, conceptualization of culture based on Hofstede (1980), a brief description of the Hofstede-Gray framework and some attempts to refine the Hofstede-Gray framework on theoretical basis from subsequent researchers. Other researcher such as Bik (2010) uses House et al.' cultural dimensions¹ (2004) in his cross-cultural study of assurance professionals behaviors. House et al.' cultural dimensions are the outcomes of 10-year research project called GLOBE (Global Leadership and Organizational Behavior Effectiveness) by measuring cultural practice and cultural values from 62 societies. Nevertheless, this cultural framework will not be used in this paper since it is not used as a framework in accounting.

Prior the Hofstede-Gray framework

Culture is one factor which helps to explain the differences in accounting systems across countries. Violet (1983) is the earliest author who explicitly recognized culture as a cause of differences in international accounting. He examined accounting system as a social function (a

product of its culture) and therefore the success of international accounting standards (IAS) is limited by cultural variables because cultural relativism exists even in the most basic of societies. Cultural relativism implies that one group should not judge other group's activities based on its criteria because the fundamental attributes are different from one society to another (Hofstede and Hofstede, 2005). Nevertheless, Violet (1983) did not attempt to classify different patterns of culture-specific factors which allow a better understanding of the influence of environmental factors on accounting development.

The importance of culture was recognized in a methodological framework proposed by Harrison and McKinnon (1986). The framework was used to evaluate the impact of culture on the form and functioning of accounting in corporate financial reporting regulation at the nation specific level. In his framework, culture is an essential factor in explaining how societal systems change since 'culture influences (1) the norms and values of such systems; and (2) the behavior of groups in their interactions within and across systems' (Harrison and McKinnon, 1986).

Hofstede's Cultural Dimensions

Culture is a complicated topic to address because it has no exact definition, it is continuously affecting and affected by many contextual factors and it is hard to objectify and assess (Papamarcos et al., 2006). A research conducted by Hofstede (1980) is one of a path-breaking research in conceptualized differences between national cultures and suggesting ways in which cultural factors may have consequences on people and organizations. Hofstede (1980) defines culture as 'the collective programming of the mind which distinguishes the members of one human group from another'. He uses the word "culture" to describe the entire societies and "sub-culture" for groups within societies. His work appeals to many researchers in social science fields such as behavioral and organizational research.

The Hofstede-Gray's Framework

Gray (1988) advanced the idea that culture might have influences on accounting practices by exploring the extent of cultural differences identified by Hofstede (1980) may explain differences in accounting systems. He used the societal values dimensions of Hofstede (1980) as cultural factors which might influence accounting practices through the accounting values. He proposed specific hypothesis to examine the form of these relationships. His proposition was the

first literature which attempted to link societal values with accounting practices in the international accounting literature (Chanchani and MacGregor, 1999). Although he did not examine his framework on empirical basis, subsequent researchers evaluated his framework both from a theoretical basis and empirical evidences.

Evaluation of the Hofstede-Gray framework on theoretical basis

There have been some literatures that attempt to extend or refine the Hofstede-Gray framework on a theoretical basis. Perera (1989) and Perera and Matthews (1990) suggest that accounting values have a considerable influence on accounting practices. He provided an analysis relating accounting values to certain aspects of accounting practices particularly in the context of developing countries' accounting systems. Fechner and Kilgore (1994) proposed a modified framework to explain cultural influence on accounting. They suggested that culture dimensions (i.e. societal values) and economic factors have moderating influence on the relationships between accounting values and accounting practices. In their modified framework, societal values have no direct influence on accounting values which is different from the Hofstede-Gray framework. Similarly to Gray, these subsequent studies provided no indication of how the numerous variables in the framework may be operationalized, the extent to which they may interact, and how statistical test might be conducted to examine the interactions between the variables (Chanchani and MacGregor, 1999). Using Germany as a case study, Heidhues and Patel (2011) criticized the Hofstede-Gray framework as misleading and fail to enhance the understanding of differences in accounting practices/systems. Using Hofstede's value scores for Germany, they evaluated the graphical mapping of Germany in cultural areas of Gray and concluded it as being imprecise and too simplistic. They apply a 'more holistic approach' in examining the factors that distinguished German accounting system from other accounting models. This approach provides additional insights such as specific characteristics in Germany accounting systems i.e. strictly confidential which has major complications with the adoption of IFRS. They recommend that further cultural research should lie on 'a critical examination of contextual environments of countries rather than a focus on measurement, quantification, simplification and categorization' (Heidhues and Patel, 2011, p. 282).

Conclusion

Recall the research question: Impact culture have on accounting practices especially IFRS practices?, it can be concluded that culture, to a certain extent, have an influence on the practices of IFRS, particularly in disclosure practices. According to the recent empirical studies that involved IFRS within their research design, culture is likely to influence the level of information disclosed, through accounting value secrecy, on the IFRS practices. With regards to measurement practices, culture, through accounting value conservatism, is expected to have less influence on the practice of IFRS, suggested from a recent study from Tsakumis (2007) that found no support for conservatism. Institutional consequences such as capital markets and legal systems may be other influencing factors that explain insignificant mean response differences in accountants' attitudes of Tsakumis (2007) study. By reviewing recent empirical literatures, this paper demonstrates the importance of culture in financial reporting practices/systems. A strand of accounting literatures are available with regards to economic consequences of IFRS adoption i.e. lowering cost of capital and improved market efficiency (Karamanou et al. 2005; Daske et al., 2008; Guggiola, 2010). It seems that more attentions are given to the consequences of IFRS rather than investigating the cause of different degrees of compliance across countries that adopted IFRS. Mandatory adoption of IFRS in Europe gives access to investigate whether culture still plays a role in the financial reporting practices under a uniform set of accounting standards. Therefore more effort is still needed, in the form of empirical studies, from international accounting researchers to understand how culture influences accounting practices/systems.

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