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The IFRS Adoption Reform through the Lens of Neoinstitutionalism: The Case of the Russian Federation

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ABSTRACT

This study examines the impact of IFRS adoption and concurrent regulatory reforms on the reporting quality of Russian public firms. Unlike much of the prior literature focusing on the economic and legal explanations of the IFRS adoption, we build on the *neo-institutional* theory of DiMaggio and Powell (1983, 1991). We show that changes in reporting quality, as measured by value relevance of information and the degree of conditional conservatism, are a function of the type of isomorphic pressure within a country. We find that firms that experienced *coercive*, *mimetic,* and *normative* societal pressures—those that both adopted IFRS and were affected by other regulatory reforms—experienced significant improvements in reporting quality. We do not find such evidence for firms that experienced only *coercive* pressure—those that were affected by changes in regulations but were exempt from the IFRS reporting requirement. Overall, the study sheds light on complexity of the interplay between external pressures and a wide array of internal pressures on public firms to adopt IFRS. Notably, the study's unique research settings allows us to achieve a better identification strategy, compared to prior IFRS studies that attempted to disentangle the IFRS adoption and regulations/enforcement effects. Our findings indicate that the incremental "IFRS adoption" effect on reporting quality was significantly positive, whereas the individual "regulations" effect was non-detectable.

1. Introduction

This study examines changes in quality of reported information due to mandatory adoption of IFRS in one of the leading emerging markets: the Russian Federation. According to the World Bank, emerging, or transitional, economies are low-income countries with significant growth opportunities that come at a price of high investment risk (The World Bank, 2013). Among all emerging economies, the countries of BRIC—Brazil, Russia, India, and China—are most likely to sustain high economic growth in the next several decades, primarily as a result of economic liberalization. All four BRIC countries have committed to adoption of IFRS, but each has followed a unique route on the way toward the implementation of this goal. Nevertheless, the BRIC countries share one common feature in that they chose an accelerated adoption of/convergence with IFRS, demonstrated by their continuous needs for capital in order to sustain high economic growth and remain in the leading position among all emerging markets.

This study focuses on the Russian stock market due to the fact that the IFRS adoption reform in this country is the most recent among the BRIC nations and its consequences remain unexplored in the empirical literature. In the last decade, the Moscow Exchange has been ranked among the top European platforms in terms of the trading volumes and market capitalization of listed companies (World Federation of Exchanges, 2013). Additionally, the Russian blue chips have occupied the leading position in the London Stock Exchange's market of Global Depositary Receipts (GDRs) (Kim, 2013b). Given the impressive size and economic

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significance of the Russian stock market among all transitional economies, the evidence of changes in information quality as a result of Russia's recent reporting reforms are of interest to the global investment community.

Prior literature produced mixed results regarding the economic consequences of adoption of IFRS on a national level. Ball (2006) argued that the reason for these mixed findings across nations is that firms' reporting incentives are endogenously determined by local economic and political factors. To the extent that these factors differ across markets, it is unlikely that IFRS adoption successes will be uniform. Among these country-level factors are legal systems and levels of enforcement (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997), financial markets infrastructures, and tax and ownership laws (Ball, 2006; Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003; Daske, Hail, Leuz, & Verdi, 2008). Importantly and more recently, the literature stepped away from these purely economic and legal explanations of IFRS adoption consequences and applied a novel, complementary framework which is grounded in the *institutional* theory of sociology. For a sample of 71 countries, Alon and Dwyer (2014) reported that under a wide array of external isomorphic pressures and conditional on the degree of resource dependency, countries choose a particular IFRS adoption strategy: to require, permit, or not allow IFRS. Judge, Li, and Pinsker (2010) found that external institutional pressures were predictive of countries' adoption of IFRS, based on the sample of 132 nations with different origins and IFRS adoption strategies. By adopting IFRS, the authors argue, nations signal their participation in the legitimate global models.[1] When examining reporting strategies of multinational corporations, Cannizzaro and Weiner (2015) documented that societal expectations dominate agency-theory motivations, such as securing external finance, in determining the scope of disclosure and transparency. The importance of societal values to corporate reporting practices was also emphasized in the studies of Hope (2003) and Salter, Kang, Gotti, and Doupnik (2013).

Our study contributes to this more recent stream of literature, seeking to explain IFRS adoption consequences from a non-economic perspective, and our predictions are grounded in the *neo-institutional* framework of DiMaggio and Powell (1983, 1991) and Scott (2001). Nevertheless, our study is different from the above-mentioned works in that, instead of focusing on a country's external pressures and legitimacy concerns within the global context, we differentiate firms by the type of isomorphic pressure *within* a single country. This is an important distinction from previous works because, when the IFRS adoption consequences are analyzed on a country level, the outcome is averaged across all public firms and may be non-existent. Consistent with this claim, we report that based on the entire sample of public firms, the impact of IFRS adoption on reporting quality is virtually non-detectable. However, when public firms are categorized by type of isomorphic pressure within Russia, the findings regarding the IFRS adoption consequences for certain categories of firms are strong and robust. We find that the firms that adopted IFRS and experienced pressures from other reforms significantly benefited from adoption of IFRS, as opposed to the firms that were only under pressures of other regulatory reforms. Consequently, the external institutional pressures are not necessarily predictive of the country's IFRS adoption success and firms' strategic responses to this reform. Rather, internal isomorphic pressures shape differential consequences of IFRS adoption for various categories of public firms. Finally, we argue that for an emerging economy whose reporting environment is characterized by a high degree of uncertainty, the success of IFRS adoption crucially depends on the existence of an *archetypal* group that had already benefited from adopting IFRS prior to the national reforms. In our study, this exemplary group is represented by Russian blue chips that had successfully listed on the world's leading markets since the 1990s.

Next, prior literature that provided voluminous evidence on the IFRS adoption consequences struggled to differentiate between the effects of the IFRS adoption and other enforcement/regulation reforms. Christensen, Hail, and Leuz (2013) argue that one of the key empirical concerns is that adoption of IFRS is likely to coincide with numerous regulatory and institutional changes, making it difficult to identify the precise source of post-adoption benefits. Accordingly, positive changes in the reporting environment around the IFRS adoption date may not be driven by this reform at all, or they may be driven by the combination of the IFRS adoption and other reforms. Daske et al. (2008) found that the IFRS adoption capital-market effects were the strongest among the European Union (EU) countries, compared to other nations. Nevertheless, the authors acknowledge that this result can be attributed to the contemporaneous changes in enforcement and regulations within the EU. For a global sample of IFRS adopters, Christensen et al. (2013) reported that concurrent changes in regulations play a major role in positive changes in the liquidity benefits, as opposed to the IFRS adoption reform. Yet, Barth and Israeli (2013) pointed to research design limitations in the study of Christensen et al. (2013) that make it difficult to validate the inferences, and they call for more research that would tackle the complex issue of identification of the individual IFRS adoption/regulations effects.

This study, which is based on the Russian market, provides unique research opportunities to achieve a better identification strategy compared to prior studies. It allows for disentangling of the "IFRS adoption" from the "regulations/enforcement" effect, thereby making an important contribution to the IFRS adoption literature. Concurrently with IFRS adoption, the Russian government instituted a number of regulatory reforms intended to improve the capital market conditions in Russia and to facilitate a smooth transition to IFRS. The Russian public firms examined in this study fall into three categories: 1) firms that did not switch to IFRS due to exemptions and continued reporting under the local standards in the post-adoption period (S1, affected by changes in regulations but not affected by IFRS adoption); 2) blue chip firms that were cross-listed overseas, already reported under IFRS, and that were subject to the stringent reporting requirements (S21, not affected by changes in regulations or IFRS adoption); and 3) firms that switched to IFRS (S22, affected by both changes in regulations and IFRS adoption). Comparing changes in value relevance of information through difference-in-difference estimation in the pre-post adoption periods for S1 versus S22 (S1 versus S21) allows identifying the incremental IFRS adoption effect (the individual effect of regulations). We find that, combined, the

[1] See also related studies of Guerreiro, Rodrigues, and Craig (2012), Hassan, Rankin, and Lu (2014), Rodrigues and Craig (2006), and Touron (2005).

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