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The Impact of IFRS Adoption on Firm Performance: Evidence from Sri Lanka

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ABSTRACT

Since extant literature does not possess empirical evidence on the impact of International Financial Reporting Standards (IFRS) adoption in Sri Lanka, the present study attempts to investigate the impact of IFRS adoption on performance of listed companies in Sri Lanka. Therefore, the purpose of this paper is to investigate whether there is a significant change in financial and market performance of listed companies in the Colombo Stock Exchange (CSE), Sri Lanka. Data related to financial performance of all listed companies from 2009 to 2016 which includes data of pre-IFRS adoption period (2010 - 2011) and post-IFRS adoption period (2012-2016) were collected from audited financial statements. Stock market performance of selected companies was computed based on data available in the CSE data library. Descriptive statistics and Analysis of Variance technique were used to obtain statistics to test the hypothesis of the present study. Empirical evidence of the study indicates that there is a significant change in firm performance of Sri Lankan listed companies after the IFRS adoption. This study adds new findings to the accounting literature by investigating the impact of IFRS adoption in Sri Lanka.

1. Introduction

Enabling a universal practice for fast-changing accounting world, IFRS were introduced by the International Accounting Standards Board (IASB) in 2001. Previously, International Accounting Standards were issued during 1973-2001 by the International Accounting Standards Committee (IASC) (predecessor of IASB). First, IFRS aimed at harmonizing accounting practices of the European Union. Later the harmonizing process rapidly spread across the world. This harmonization was well-supported because economic and financial barriers among different countries were fading due to international trade, technological advancement, development of global financial markets and the emergence of multi-national companies. In 2009, the Accounting

Standard Committee (ASC) together with the Institute of Chartered Accountants in Sri Lanka (ICASL), the accounting body for issuing accounting standards in Sri Lanka took a decision to fully adopt IFRS. In 2012, IFRS were introduced to Sri Lanka as Sri Lanka Accounting Standards corresponding to the IFRS (SLFRS) by ICASL. From 1st January 2012, it became mandatory to all Specific Business Enterprises to report their financial accounting process according to IFRS (The Institute of Chartered Accountants of Sri Lanka, 2019).

IFRS attempts to improve the effectiveness of common usage of financial reports, ensure value of information communication through financial statements, and enhance the ability to compare and transparency of accounting numbers in financial statements (Joshi, Yapa & Kraal, 2016). However, adopting IFRS is quite challenging as it requires disclosing of more information, incurring costs in transforming existing accounting practices to IFRS, and mitigating the influences from present socio-technical factors of an organization. Various authors such as Gonzalez *et al.* (2014), Abata (2015), Espinosa *et al.* (2015), Black and Maggina (2016), Stent *et al.* (2010), and Bayerlein and Al-Farooque (2012) have conducted research to examine the influence of adopting IFRS on organizations. Espinosa *et al.* (2015) using the data of an emerging market (i.e. Chile) reported that adopting IFRS induces a significant variation in financial performance. They also found that market response to the implementation of IFRS is neither an incentive nor a punishment. Another study by Black and Maggina (2016) on the influence of IFRS on accounting numbers of selected Greek firms found that IFRS had not improved the magnitude of financial ratios. Besides, results of the study indicated that use of IFRS does not enhance the effectiveness of financial reports. Stent *et al.* (2010) have conducted a study to investigate the effects of IFRS on financial reports and financial indicators of New Zealand (NZ) firms. Results of the study revealed that 87% of NZ firms were affected by the IFRS. According to their findings, the impact of IFRS for most firms was low whereas the impact was considerable for several organizations and the effect on financial indicators was significant too. A study by Gonzalez *et al.* (2014) which examined the influence of IFRS on financial reports indicated that there were significant changes in income statement items and items of the statement of financial position. Another study by Bayerlein and Al-Farooque (2012) concluded that mandatory IFRS adoption creates a substantial harmonization of taxation and goodwill accounting of three countries - Australia, Hong-Kong and the UK. Abata (2015) found that IFRS adoption provides better information for regulators than Generally Accepted Accounting Principles in the Nigerian context. Nijam (2016) in his study evaluated the financial reporters' perspectives on the influence of IFRS implementation in Sri Lanka. Subsequently the study reported that financial reporters posit a view point that IFRS implementation significantly improves the quality of financial reports and the level of corporate governance in banking, finance and insurance sector firms.

As discussed above, IFRS adoption impacts on performance of firms in developed, emerging and developing countries in a varied manner. However, the findings of relevant past studies (i.e. Espinosa *et al.*, 2015; Gonzalez *et al.*, 2014) cannot be replicated to Sri Lanka due to difference in time periods of countries which adopted IFRS and socio-cultural, economic, political, technical and legal factors. Difference in the ownership structure, governance practices of respective countries and their legal systems are affecting the IFRS applications (Black & Maggina, 2016). Sri Lanka embraced the IFRS with lot of expectations with regard to improving the level of present financial reporting practices and firm performance. It is also to be noted that there is no research available in extant literature to evident how IFRS adoption impacts performance of Sri Lankan firms. A possible reason for this might be that IFRS were brought in to practice in Sri Lanka in 2012 thus researchers might wait for some time to elapse in order to investigate this impact. Therefore, the present study attempts to examine how mandatory IFRS practices impact on the performance of Sri Lankan firms. More specifically, it attempts to investigate the effect on financial and market performance upon adopting IFRS by selected Sri Lankan listed companies for this study.

Remaining parts of this paper is arranged in the following manner. Next section, Section 2, reviews past studies on IFRS adoption. Section 3 develops hypothesis based on the outcome of literature review. Section 4 explains the methodology adopted in this research. Empirical findings of the study are discussed in Section 5, and Section 6 includes concluding remarks.

2. Literature Review

2.1. IFRS adoption in different countries

Some researchers have highlighted the importance of IFRS for emerging and developing nations. According to Tyrrall *et al.* (2007) "advantages to developing nations of harmonizing IFRS include: the elimination or reduction of set-up costs in developing national accounting standards; the potential for rapid national improvement in the perceived quality and status of financial reports; increase in market efficiency in (inter) national financial markets through the provision of more understandable, comparable, and reliable financial statements; and a reduction in the cost to firms of preparing financial statements". Wolk *et al.* (1989) argue that harmonizing accounting practices internationally is beneficial for developing countries because the harmonization facilitates with enhanced financial reporting practices which include an improved accounting framework.

A recent trend shows that IFRS are increasingly being applied in emerging and developing nations. According to Samaha and Khlif (2016) many developing nations implement IFRS even without considering the level of effectiveness in their existing financial reporting systems. Although there is a significant attention to embrace IFRS a handful of empirical studies available in the extant literature to evident how IFRS influences financial reporting practices of these nations (Ismail *et al.*, 2013). Samaha and Khlif (2016) also maintain a similar viewpoint that research findings on economic consequences of IFRS in developing nations are limited. Garanina and Kormiltseva (2013) highlighted a laxity of research on the effects of IFRS implementation. Chebaane and Othman (2014) state that "despite the growing adoption of IFRS by emerging economies and developing countries a little attention is assigned to study the consequences of IFRS adoption in emerging and developing economies".

Therefore, examining the effects of IFRS using data from a developing nation would address the above-mentioned empirical gap due to the following reasons. First, there has been a considerable debate over the value relevance of accounting information prepared under IFRS compared to the local sets of accounting standards (Alali & Foote, 2012). Second, although a large number of studies based on developed countries indicates the impetus of IFRS practices the same findings may not be applicable to emerging and developing nations due to differences in economy and society (Hofstede, 2001, Ismail *et al.*, 2013). Third, it has been argued in the literature that IFRS are highly advanced standards which need developed economic environment to successfully apply (Chebaane & Othman, 2014; Tyrrall *et al.*, 2007), and Perera (1989) argues that IFRS are less effective for developing countries due to their complexities. Fourth, a number of developing nations have implemented IFRS recently by partially disregarding the concern of the relevance of IFRS to their economies (Samaha & Khlif, 2016; Tyrrall *et al.*, 2007). Fifth, despite this widespread recognition for IFRS in emerging and developing economies, less number of empirical studies have investigated the effect of IFRS (Ismail *et al.*, 2013; Chebaane & Othman, 2014), and few empirical research that examined the effects of IFRS also present mixed results (Okafor *et al.*, 2016). Further, the findings from the limited research also may not be applicable to an another country like Sri Lanka because of the influence of country-specific factors (Ali & Hwang, 2000; Barth *et al.*, 2001; El-Gazzar & El-Sadek, 2001).

2.2. Accounting practices of Sri Lanka

Historical evolution of accounting practices differ from country to country (Chairas & Radianto, 2001). An exploratory investigation by www.afaanz.org reveals accounting and financial reporting practices of Sri Lanka are affected by political, legal, economic and cultural factors in the country. Yapa (2006) states that "the government of Sri Lanka introduced the trade liberalization in 1977 which resulted additional disclosures being demanded by the investors and created demand for professional accountants to improve the country's accounting and disclosure practices". According to Lawrence (1996) legislature of a country influences its accounting practices. The legislature contains details of rules and procedures of accounting practices (i.e. Companies Act, No. 07 of 2007; Sri Lanka Accounting and Auditing Standards Act, No.15 of 1995). Lawrence (1996) also states that open economy in Sri Lanka influences to induce a comprehensive mechanism to disclose quality accounting information. Finally the study reveals that the British colonial system influenced the early days of financial reporting practices of Sri Lanka. The IFRS adoption has been driven by International Federation of Accountants (IFAC), IASB and the World Bank. In 2012, IFRS were introduced to Sri Lanka as Sri Lanka Accounting Standards corresponding with the IFRS (SLFRS) by the ICASL. From 1 January 2012, it became mandatory for all Specified Business Enterprises to carry out their financial accounting process in accordance with IFRS (ICASL, 2019).

2.3. IFRS adoption and firm performance

Accounting information generated using IFRS emphasizes more on information related to firm performance (Adams *et al.*, 1993). Using data of 40 listed companies in Zimbabwe, Chamisa (2000) investigated the importance and compliance of IASC standards. Findings of the same study showed that the selected firms for the study are strongly complying with some requirements of IAS. Umobong (2015) has carried out a research based on data of 16 listed food and beverages producing firms in Nigeria during 2009-2013. The author has reported that variation in market performance during pre and post-IFRS periods are not statistically significant. Jermakowicz and Gornik-Tomaszowski (2006) have shown that economies with open financial markets are preferred to implement IFRS. Umobong and Ibanichuka (2016) have investigated the effect of IFRS on firm's financial performance using listed food, beverage and pharmaceutical firms on Nigeria Stock Exchange from 2006-2014. Their findings indicate that no significant difference between mean of return on assets, return on equity and earnings per share before and after adopting IFRS. Khaled and Khlif

(2016) have tested the impact of IFRS practices of developing countries. The study documented that IFRS are contributing to improve and raise the professional level of accounting, decision accuracy of external investors and contribute in the advancement of the stock markets and to improve the process of comparison, analysis and discussion of financial information. Abdullahi *et al.* (2017) have carried out a study to find the relationship between IFRS and performance of oil and gas companies in Nigeria. Empirical evidence of this research highlights an absence of an improvement in the performance of sample companies.

A study by Latridis and Rouvolis (2010) documented that IFRS has induced some key changes in income statement and balance sheet items of 254 companies listed on the Athens Stock Exchange during 2004-2006. Furthermore, the same study has reported that financial indicators of firms have enhanced significantly after adopting IFRS. Pascan and Turcus (2012) have investigated the effect of IFRS on performance of 14 Romanian companies quoted on Bucharest Stock Exchange using financial data of 2007. The study found a slight change in the profitability reported in income statement. In addition, they revealed that the influence of IFRS on performance of selected companies for the study varies from one company to another. Senyigit (2012) has examined and found an absence of difference in the equity of Turkish insurance industry before and after the IFRS adoption. Ferentinou and Anagnostopoulou (2016) have studied the effects of IFRS and accrual-based earnings management (AEM) and real earnings management (REM) in Greece. Results of the study reveal that IFRS has made a statistically significant changeover from AEM to REM. In Romania, Brad *et al.* (2014) have found that IFRS impacts on performance of organizations which have taken initiatives to apply IFRS. Mironiuc *et al.* (2015) have carried out a study based on the data collected from 65 Romanian companies listed in the Budapest Stock Exchange from 2011-2012. Empirical results show that the effectiveness of financial information of Romanian financial market was increased after adopting IFRS. Mhedhbi and Zeghal (2016) have examined the relationship between IAS and performance of emerging capital markets selecting 31 developing markets. Findings of the study highlight that the performance of developing markets has a strong positive association with IAS/IFRS. Santos *et al.* (2016) have examined the influence of IFRS on financing structure of emerging economies. It reveals that IFRS usage in financial decisions is very much similar in selected companies for the study though they represent different regions and different nations. Kim and Ryu (2018) have tested the effect of mandatory IFRS implementation on capital markets using listed Korean companies during the period 2000-2013. The analysis of the study confirmed a decline in equity capital cost of the sample firms after adopting IFRS in 2011. In Indian context, Susruth (2016) has conducted a research on the influence of adopting IFRS on financial statements. The author has concluded that IFRS would increase the consistency of financial statement items of different organizations. Sampaio *et al.* (2017) based on 595 Brazilian firms from 2004 to 2015 predicted the association between mandatory IFRS implementation and firm value. Sampaio *et al.* (2017) report a positive association between net income and value of the firm.

Perramon and Amat (2006) have examined the impact of IFRS application on quoted public companies in Spain. The authors have documented that IFRS practice of listed non-financial firms in the sample impacts diversely on their profitability. Daske (2006) studied the economic benefits of adopting IFRS using data of 735 German companies. In this regard, the author has found that changing of local financial reporting practices to international accounting standards did not cause any benefit to the selected organizations. In Portuguese context a study by Silva and Couto (2007) has examined the effect of IFRS on financial information. Findings of the study reveal a structural change occurred in the composition of balance sheet and income statement of sample firms after adopting IFRS. Hung and Subramanyam (2007) have investigated the impact of IAS on financial reports of selected German companies from 1998 - 2002. They have disclosed that total assets, net book value of equity and the variation in net income are substantially higher in IFRS compared to German Accounting Rules. O'Connell and Sullivan (2008) have investigated the results of converting to IFRS of FTSEurofirst 80 companies and found an important increase in net income of firms after converting to IFRS. Similarily, Latridis (2010) has found that IFRS adoption in the UK has a positive impact on financial performance.

The literature review carried out thus far evident an existence of mixed findings for the effects of IFRS implementation on performance of the firm. In this regard some studies have reported positive influences from IFRS on performance of the firm (i.e. Khaled & Khlif, 2016; Latridis, 2010; Armstrong *et al.*, 2008). In contrast several studies (i.e. Abdullahi *et al.*, 2017; Kim & Ryu, 2018; Umobong & Ibanichuka, 2016) have found negative impact from IFRS on performance of the firm. Meanwhile, Franzen and Weibenberger (2018) report inconclusive association between IFRS practices and firm performance. It is apparent that there is a growing tendency in many different contexts to examine the effects of IFRS on firm performance (Umobong, 2015; Santos *et al.*, 2016; Sampaio *et al.*, 2017; Franzen & Weibenberger, 2018). Having considered the absence of such study in Sri Lanka and the appearance of various contextual factors which hinder the replication of extant research findings related to other countries on IFRS practices and their influence on company performance, the present study attempts to examine how mandatory IFRS implementation impacts on firm performance of listed Sri Lankan firms.

3. Hypothesis development

Financial reports which prepared under financial reporting standards as recommended by the ICASL were selected for this study. Therefore, financial information presented in financial statements is the input of different financial indicators calculated to measure financial performance of a firm. Moreover, there are different stakeholders of the firm including investors who make their decisions based on information presented in financial statements. Arguably, the information created in financial reports using financial reporting regulations are reflected in stock market performance of a firm. The same construction was studied by Khaled and Khlif (2016) in Libiya and found that IFRS adoption contributes to an advancement of stock markets. The authors such as Kim and Ryu (2018) and Sato and Takeda (2017) could be taken as examples to evident this association. Moreover, the past researchers such as Silva and Couto (2007) found that there is a significant change in firm performance measured through financial information of firms before and after the IFRS adoption. Corresponding to these establishments in prior research, the present study develops the following hypothesis to be tested using the data of selected firms for the study.

H_1: There is a significant change in firm performance after IFRS adoption, in which

H_{1a}: There is a significant change in financial performance of firms after adopting IFRS

H_{1b}: There is a significant change in market performance of firms after adopting IFRS

There are two variables used in H_1 of the study. They are financial performance and market performance. The study uses two indicators for financial performance namely productivity and profitability of firms. According to Pal and Soriya (2012) productivity of the firm is measured through asset turnover ratio (ATO) (Revenue/Total Assets). Profitability of the firm is measured using two ratios namely return on assets (ROA) and return on equity (ROE). ROA ratio uses to gauge the efficiency of using given assets by the managers to create value to the firm. ROE ratio is more referred by the owners of the firm to measure the portion of value addition done by the firm on their investments. According to Espinosa *et al.* (2015), ROA is calculated as a ratio of earnings before interests and tax divided by average assets of the firm. ROE is net income of the firm divided by average equity (Espinosa *et al.*, 2015). Market performance of the firm is measured using annual share return of the firm. The following formula is used in this respect.

$$ASR = \frac{P_1 - P_{t-1}}{P_{t-1}}$$

ASR = Annual share return

P_t = Market price at the end of the year

P_{t-1} = Market price at the beginning of the year

4. Methodology

4.1. Sample and data

Preparation of financial reports according to IFRS guidelines became mandatory for Specified Business Enterprises of Sri Lanka since 1 January 2012. Out of the Specified Business Enterprises as classified by Sri Lanka Accounting and Auditing Standard Board, this study purposefully selected all the companies listed in the CSE. In this respect, data from all 294 companies which maintained their listing status by 31 March 2016 were collected. Sample period for the study was 2010 to 2016 which includes data of pre-IFRS period (2010 and 2011) and post-IFRS period (2012-2016). Nevertheless, data of 96 companies were eliminated (198 retained) due to such companies were not listed on the CSE during both the sample periods. Secondary data on financial performance of firms were collected from audited financial reports of sample companies of the study. Additionally, the market performance of the companies is computed based on stock market data available in the CSE data library.

4.2. Data analysis

In examining the existence of significant differences in mean values of performance indicators of pre-IFRS sub sample and post-IFRS sub sample, a single factor analysis of variance (ANOVA) was carried out for each of the performance indicators. Using the results of the analysis, the following hypothesis was tested in order to affirm H_{1a} and H_{1b} of the study.

H_0: "Difference of means between two sub-samples equals to zero"

H_1: "Difference of means between two sub-samples do not equal to zero"

5. Empirical Results

Before employing ANOVA technique to draw empirical evidence to test hypothesis, the collected data for this study are summarized and presented using summary statistics. Table 1 shows a comparison of summary statistics of data related to pre-IFRS (Pre) and post-IFRS (Post) periods.

Table 1
Summary statistics

	ATO		*ROA*		*ROE*		*ASR*	
	Pre	*Post*	*Pre*	*Post*	*Pre*	*Post*	*Pre*	*Post*
Mean	0.67	0.73	0.05	0.08	0.04	0.06	0.01	0.03
Maximum	3.24	6.23	0.60	1.05	0.43	0.62	1.24	12.84
Minimum	0.01	0.00	-0.25	-0.26	-0.97	-0.83	-0.92	-0.94
SD	0.63	0.78	0.10	0.13	0.10	0.12	0.31	0.63
Skewness	1.51	3.05	1.67	3.61	-3.17	-0.66	0.62	14.23
Kurtosis	5.65	18.12	10.69	24.69	38.07	17.59	4.71	28.18

Note: Number of observations is 396 and 792 in pre and post IFRS periods, respectively

According to Table 1, average value of all performance indicators of selected firms for this study has increased after adopting IFRS. Maximum level of performance of firms has also been increased after adopting IFRS whilst, the minimum level of performance has been almost consistent before and after adopting IFRS. This pattern indicates that some companies have managed to yield extremely high performance. Increase in standard deviation (SD) values and the change in skewness values related to all performance indicators in post-IFRS adoption support the above observation. Moreover, a drastic increase in kurtosis value of performance indicators (except for ROE) during post-IFRS adoption period indicates that performance of selected firms have started to gather around the mean value. As stated in the previous section, the study uses a single factor ANOVA to draw empirical evidence to test the hypothesis of the study.

The results of the test are presented in Table 2.

Table 2
Summary of ANOVA test

Variable	*F-statistic*	*P value*
ATO	6.48	0.01[a]
ROA	3.89	0.05[b]
ROE	4.15	0.04[b]
ASR	19.18	0.00[a]

Note: *F*-critical value is 3.87; [a]significance level is 0.01; [b]significance level is 0.05

As per the statistics in Table 2, a statistically significant difference in mean values of financial (ATO, ROA and ROE) and market (ASR) performance before and after adopting IFRS by selected firms for the study can be evident. As per Table 1, the mean value of all the performance indicators has increased in the post-IFRS period. Therefore, H_{1a} and H_{1b} of the study can be established in relation to the listed companies in the CSE.

The finding of a significant increase in firm performance related to both financial performance and market performance after the IFRS adoption can be compared with similar studies reported in literature. The findings of Latridis and Rouvolis (2010) are consistent with the present study with a highlight of improved financial indicators in Greek companies after adopting IFRS. This finding is contradictory to a negative influence on performance of the firm after the IFRS adoption in selected developing countries as reported in Khaled and Khlif (2016). In contrast to the findings of the present study, Black and Maggina (2016) documented that IFRS adoption has not improved the statistical behavior of financial ratios of selected Greek companies. Furthermore, the same authors have reported that the level of quality of data in financial reports of Greece has not improved upon adopting IFRS. Pascan and Turcus (2012) have revealed that the effects of IFRS on firm performance differ from one company to another. According to Schipper (2005), such contrasting effects are possible due to different cultures, legal requirements and financial systems. Santos *et al.* (2016) have carried out a study on the adoption of IFRS and its impact on financial structure of companies in emerging markets. It is stated that the influence of IFRS in financial structure of companies differ from each other. In this respect, the findings of the present study would evident the robustness of their findings.

6. Conclusion

Before adopting IFRS, Sri Lankan companies used to follow Generally Accepted Accounting Principles. From 2012 onwards, Sri Lankan companies adopted IFRS. Corresponding to this changeover, the aim of this research was to examine whether there is a change in firms' performance after adopting IFRS. According to the ANOVA results, it is evident a significant improvement in both financial and market performance of sample companies selected for the study.

Reflecting on the findings of the present study, it could conclude that Sri Lankan companies and policy making bodies have adequately fulfilled the key success factors in making a significant effect from IFRS adoption on firm performance. Further, it was evident in the study that firms' performance has been increased upon IFRS adoption in Sri Lanka. The introduction of new, improved and comprehensive accounting standards under IFRS has allowed investors to trust on the accuracy of the comparability of firms' performance in making their portfolio investment decisions. Regulatory bodies such as Securities and Exchange Commission in Sri Lanka, CSE and ICASL can use the findings of the present study to attract foreign investors by effectively communicating the influence of IFRS on the performance of firm. So far the preparation of financial reports as per the IFRS is mandatory for SBEs in Sri Lanka and a large number of organizations either not preparing financial statements at all or preparing according to accounting regulations existed before introducing IFRS. Therefore, the regulatory bodies may take necessary steps to educate such organizations about the benefits of preparing financial statements using IFRS to improve their accounting practices as evident in the present study.

The present study is not free from certain limitations. As Sri Lanka a developing nation findings of this study would not directly applicable for developed and some emerging countries. There was a practical difficulty in finding data before the adoption of IFRS (i.e. before 2011). Hence, the sample period for pre-IFRS adoption was limited to two years (2011 – 2012). Given the quantitative approach in the study, the perceptions and viewpoints of interested parties on IFRS adoption are not contained in the study. Despite the above limitations, the present study adds new attributes to existing literature on how mandatory IFRS adoption influences on the performance of quoted public companies in Sri Lanka. Future researchers could pay attention to design their studies to address the above limitations and at the same time, comparative cases for different contexts can be conducted to seek diversities exist in IFRS adoption and how differently the adoption makes changes in overall organizational conduct.

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