CHAPTER 2

LITERATURE REVIEW

2.0 Introduction

The previous chapter presents the background of the convergence with IFRS as well as the research problems and objectives of this study. The purpose of this present chapter is to unearth and study the previous body of literatures published especially on the general background of institutional theory, the application of institutional theory on the IFRS convergence as well as internal barriers faced by companies to implement IFRS. Section 2.1 summarizes the extent of literatures on the background of institutional theory. Section 2.2 discusses the relevance of institutional theory on IFRS convergence. Section 2.3 until Section 2.5 provides a thorough discussion on the influences of three isomorphism namely coercive, mimetic and normative isomorphism on the preparedness of companies for the IFRS convergence. Section 2.6 details the internal barriers faced by companies to implement IFRS from the lens of resource-based views. Section 2.7 identifies the control variables in this study. And finally Section 2.8 summarizes what was achieved from literature reviews.

2.1 Background of the Institutional Theory

Historically, institutional theory has been formulated and developed between 1880 to the mid-20th century (Scott, 2008). Institutional theory has widely influences in the field of economics, political science and sociology. Various meanings and conflicting interpretations have existed in institutional theory. It is therefore not viable to conduct an exhaustive literature review of all the early institutional theory in this interdisciplinary research. This section focuses mainly on a sociological perspective of institutional theory from a few theorists in the organization field that are more relevant to this study.

The early influential concept of institutions in sociology was generally originated from the work of Herbet Spencer (Scott, 2008). Spencer (1876, 1896, 1910) defines society as an organic system evolving time and this was achieved by the functions of specialized "organs" structure as institutional subsystem. William Graham Sumner (1906) then proceeds to provide explanation of institution as "*an institution consists of a concept (idea, notion, doctrine, interest) and a structure*" (as cited in Scott, 2008, p.9). From the explanation, the "concept" defines the aims of institutional and "structure" refers to the institutions. Societal evolution has since progress from individual activities to institutional perspective (Scott, 2008).

From the early development on institutional theory, Phillip Selznick (1948) contributes to the institutional theory in an organization perspective (Scott, 2008). According to his view, organization is formed as an instrumental mechanism to achieve goals in a variable extent and will be transformed to institutions over time. He also further explains institutional as a process that influence organization over time that reflects organization's own history, group of people, the vested interest and the way it has adapted to its environment. Therefore, organization is viewed as an adaptive and organic system that influenced by the social characteristics of its participants as well as environmental pressures.

The school of neo-institutional theory emerged in the field of organizations was basically developed in the seminal work of Meyer and Rowan (1977). Based on the neo-institutional theory, organizations are influenced by institutional environment and gradually become isomorphic with them. This isomorphic process is vital to ensure the success and survival of organizations. Further, Meyer and Rowan (1977) define the concept of legitimacy as a status conferred by social actors. Externally legitimated formal structures and organizational practices may increase the commitment of an organization to internal participants and external constituents.

A significant contribution to neo-institutional theory was further developed by DiMaggio and Powell (1983) to understand why organizations are so similar in certain aspects. According to DiMaggio and Powell (1983), organizations under the same environmental conditions tend to look for legitimacy and social acceptance from other organizations in order to obtain resources and survive in an increasingly organized and inter-connected society. This institutionalization tends to reduce variety and diversity in the environment and push organizations towards legitimacy patterns. In other words, organizations must conform to institutional pressures if they intend to gain legitimacy within an organizational field. The institutional pressures that lead organizations to adopt similar practices are called isomorphism. These institutional pressures arise from three sources namely coercive, mimetic and normative isomorphism.

The neo-institutional theory was further explained and refined by Scott (1987). In his view, institutions are multifaceted and durable social structures that represented by a combination of symbolic elements, social activities and material resources. The neo-institutional theory is then developed to analyze the influences of higher level environment on lower level institutional. Scott (2008) considers three levels of social-historical relationship in the process of institutionalization: the societal level (political, economic and social system), the organizational field (socioeconomic configurations) and individual organization.

To summarize, institutional theory attempts to study organizations in relation to their environments, the effects of external expectations on organization as well as the development of structures and practices within organization when they are seeking legitimacy (Barbu and Barker, 2010). The above literatures on institutional theory provide a basic understanding on the concept of institutions and the historical development of the institutional theory. The next sections will demonstrate the influences of the three elements of legitimacy proposed by DiMaggio and Powell (1983) namely coercive, mimetic and normative isomorphism that are exerted on the IFRS convergence in Malaysia context.

1.1.5 Institutional isomorphism in the IFRS Convergence

Institutional theory has been applied widely in different disciplines that include accounting standards harmonization and IFRS adoption (Judge et al, 2010; Barbu and Baker, 2010; Al-Omari, 2010; Irvine, 2008; Hassan, 2008; Mir and Rahaman, 2005;

Touran, 2005). The wide ranges of researches using the institutional theory perspectives across different disciplines may support its integrity and usefulness to explore the IFRS convergence in the Malaysia context.

In the move towards IFRS convergence in Malaysia, the legitimacy of IFRS in Malaysia context is crucial because legitimacy justifies and explains an institution's structure and existence in the process of implementing IFRS. Furthermore, legitimacy of IFRS convergence requires the fit between an institution and its environment. From a sociological perspective, the concept of legitimacy has been defined by Suchman (1995, p.574) as

"Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs and definitions."

In regards with the legitimacy of IFRS, Irvine (2008) indicates that IFRS is a powerful legitimacy force that gives adopting nation the ability to compete in global capital market. It means that nations and organizations intend to adopt IFRS in view of the legitimizing power of IFRS to expand capital market and business globally. This is also supported by the views from Mir and Rahaman (2005) and De Lange and Howieson (2006). Added to this, Judge el al. (2010) acknowledges that countries are willing to adopt IFRS in two ways. First, under-developed countries with perceived "low quality" accounting standards have recently adopted IFRS in order to be on par with more developed countries such as UK and Australia. Second, countries even with perceived higher quality domestic accounting standards such as Australia and Canada also adopted IFRS or altered their domestic standards in order to be able to compete in global environment. Overall, institutionalization arises as there is a social process through which nations and organizations accept international accounting standards in the interests of international accounting harmonization (Rodrigues and Craig, 2007).

According to DiMaggio and Powell (1983) and Scott (1987), organizations must conform to institutional isomorphism if they intend to gain legitimacy within an organizational field. The term institutional isomorphism refers to the situation where organizations within an environment becoming more homogeneous due to political, legitimacy or social purposes. In other words, there is a tendency of the nations across global to adopt IFRS and organizations may conform to this tendency to adopt IFRS if they intend to secure legitimacy within an organizational field. There are three types of institutional isomorphism identified namely coercive, mimetic and normative isomorphism. The next sections will demonstrate the influences of the three elements of legitimacy namely coercive, mimetic and normative isomorphism that are exerted on the IFRS convergence in Malaysia context.

2.3 Coercive Isomorphism and IFRS Convergence

According to DiMaggio and Powell (1983, p.150), coercive isomorphism results from "*both formal and informal pressures exerted on organizations by other organizations upon which they are dependent, and by cultural expectations in the society within which the organizations function*."

Generally, coercive isomorphism arises from imposition of standard operating procedures and legitimated rules through government mandate as well as conformation to the social expectations of the society. Thus, it is conjectured that both formal and informal pressures are exerted on organization by various stakeholders such as political and legislative bodies, shareholders, lending institutions and public.

Accounting rules and regulation are less effective without proper enforcement (Wulandari and Rahman, 2004). Commission of the European Communities (2000) defines enforcement in accounting regulation comprises “a cascade of different elements including (1) clear accounting standards; (2) timely interpretations and implementation guidance; (3) statutory audit; (4) monitoring by supervisors; and (5) effective sanctions. Each of these must work efficiently.” (as cited in Nobes and Parker, 2010, p.230). This indicates that the quality of the enforcement in the accounting regulation is crucial to IFRS convergence.

In the move towards IFRS convergence, efforts are always being taken to review existing regulatory structures and legislation to enable greater compliance with IFRS (Chan et al., 2010). Chua and Taylor (2008) argue that government or regulators actions encourage widespread diffusion of IFRS apart from economics rationales. Further, Brown and Tarca (2005) also recognize the primary roles of regulatory oversight bodies and enforcement mechanism in promoting the adoption and compliance of IFRS in the EU member countries. This view is supported by research study conducted by

Jermakowicz and Gornick-Tomaszewski (2006) that shows the majority of EU-listed companies would not adopt IFRS if not required by EU Regulation.

In Malaysia, MASB together with FRF make up the framework for financial reporting. The enforcement of approved accounting standards is seen to reside with the Securities Commission (SC), Bank Negara Malaysia and the Companies Commission of Malaysia. The SC has the powers to enforce financial reporting requirements for public listed companies in Malaysia. The Financial and Corporate Surveillance Department in SC has the responsibilities to review financial statements of public listed companies and has the authority to direct those responsible companies to rectify and restate the relevant financial statements. Sanctions that imposed for non-compliance normally include investigation, civil proceedings, criminal prosecution, and administrative actions. This is supported by prior research that shows negative returns are associated with the restatement of financial statements (Palmrose et al., 2004).

When MASB achieves its IFRS convergence target on 1 January 2012, companies are required to follow all the standards issued by IASB in totality. Given the multiple institutional forces that regulate the IFRS convergence in 2012, listed companies are mandatory required to adopt the IFRS issued by IASB. As such, companies are coerced into preparing themselves for IFRS convergence as they develop a fear of and try to avoid sanctions and punishment from regulatory bodies (Scott, 2008).

Apart from the regulation forces, coercive pressures can arise from resource-dominant actors. This is the foundation for resource dependency theory where a dominant actor controlling resources demands that dependent organizations to adopt mechanisms that serve its interests. According to Pfeffer and Salancik (1978), organization needs to fulfill the demands of various partners for critical resources. Partners such as powerful suppliers, customers and other major stakeholders can become key institutions for organization (as cited in Heugens and Lander, 2009).

From an accounting perspective, the Conceptual Framework assumes that the main purpose of financial statements is to provide useful information to various stakeholders to enhance their economic decisions. This indicates that coercive isomorphism can arise from various stakeholders or financial reporting interest groups who demand financial information from company (Chalmers and Godfrey, 2004). In other words, changes can be imposed by various powerful external sources or constituents toward some forms of practices or structures (Tuttle and Dillard, 2007). Thus, company could be coerced to adopt IFRS in order to satisfy the expectations and demands of its powerful stakeholders.

Irvine (2008) and Mir and Rahaman (2005) indicate that international funding bodies such as World Bank exert coercive pressures to developing countries to implement IFRS. As these countries receives grants from World Bank to develop projects, World Bank has coercive power to “force” these countries to adopt IFRS or develop national accounting standards based on IFRS for the intention to encourage international investments and expand capital market globally. A growing capital market in developing countries such as Malaysia also provides sufficient grounds or justification for investors to request company's financial statements based on well-developed accounting standards or global accounting standard namely IFRS.

Prior empirical evidences show that legislation or regulation plays a significant form of pressures for organizations to adopt or pursue certain practices (Liu, et al., 2011; Clemens and Douglas, 2006). Previous accounting literatures also support coercive isomorphism on the adoption of IFRS. For example, Touran (2005) indicates that coercive isomorphism is the determinant of adoption of US GAAP by French firms in 1970s due to the domination of USA in the global economy. Mir and Rahaman (2005) argue that the major factors for the adoption of international accounting standards in Bangladesh are due to the pressures from international lending institutions and the need to provide credibility of information to international investors. Furthermore, Judge et al. (2010) support the influence of coercive isomorphism that measured by the level of foreign aid on the adoption of IFRS across 132 countries in the world. In this regards, there is a positive association between coercive forces from stakeholders and preparedness of companies for IFRS convergence.

Based on discussions above, the first hypothesis is offered:

> *H1*: *There is a positive association between coercive forces from stakeholders and preparedness of companies for IFRS convergence.*

2.4 Mimetic Isomorphism and IFRS Convergence

According to DiMaggio and Powell (1983), companies seek to model themselves on the practices of similar organizations in the same field, which they perceive to be more legitimate or successful especially in the situations of uncertainty over goals, technologies and means-end relationships. Arguably, organizations want to be seen as socially acceptable in their field. As more organizations behave in certain ways and manners, the more pressures exert on other organizations to imitate these behaviors and follow the same practices.

Haunschild and Miner (1997) distinguish three modes of inter-organizational imitation: frequency imitation (follow common practices), trait imitation (follow practices of other organizations with certain features) and outcome imitation (imitation based on a practice's apparent impact on others). Possibly, the adoption of IFRS by companies can also be influenced by these three inter-organizational imitations. For frequency based imitation, company may follow practices from majority of companies in the move towards IFRS convergence. It should also be noted that most of the nations follow the global trend to adopt IFRS as more than hundred of nations have already adopted IFRS. In term of trait-based imitation, it can be argue that organizations tend to follow new policies and procedures related to IFRS adopted by other leading organizations in their sector. Meanwhile for outcome-base imitations, organizations may be more prepared to adopt IFRS on the grounds that IFRS adoption may give benefits to organizations.

As successful multinational corporations have continually expanded their business globally, they have tendency to follow or imitate multinational organizations behaviors to achieve the desirability of the global harmonization of financial reporting (Irvine, 2008). As Malaysia economic is increasing reliance on international trade, this will bring a pressure on the multinational corporation to adopt IFRS, particularly those of its "influential trading partner(s)" from the developed countries. Furthermore, Malaysian government has focused on the internationalization of capital market in response to Capital Market Masterplan Two (CMP2) strategy (MASB, 2011a). In order to compete for capital with companies in the global capital market, multinational corporations may be more likely to adopt IFRS to provide useful information to capital market participants that usually rely on accounting information for investment decision making.

Prior literature reviews found that mimetic isomorphism influences the IFRS adoption. Touron (2005) indicates that large French companies move away from their domestic accounting standards to US GAAP due to the influences of global market trend. Furthermore, Irvine (2008) argues that mimetic pressures arise from trade partners as well as multinational corporations contribute to IFRS adoption. Lastly, Judge et al. (2010) find that mimetic pressures from import penetration exert strong positive pressure on IFRS adoption in some countries. As a result of the above discussions, the second hypothesis is proposed:

> *H2*: *There is a positive association between imitation tendencies of companies in organization field and the preparedness of companies for IFRS convergence*

2.5 Normative Isomorphism and IFRS Convergence

Normative isomorphism arises from group norms to adopt particular institutional practices. Further, normative isomorphism is view as imposing constraints on social behavior (Scott, 2008). With normative isomorphism, organizational choices are influenced by values, norms and social behaviors. Two important aspects of professionalization arise from the formal education background and the growth of professional networks. The influences of professionalization allows for the rapid diffusion of new models of changes on organizations.

The growth and elaboration of professional networks that span organizations will allow for new models to diffuse rapidly (DiMaggio and Powell, 1983). Professional institutions have influences to disseminate norms, influence the field, and otherwise direct other members (Tuttle and Dillard, 2007). Professional and trade association represent clear instances of such groups. In Malaysia, professional accounting bodies such as the MIA and MICPA play an active role to promote the IFRS adoption and provide training courses and seminars to its members. These accounting bodies encourage their members to provide input or feedback to the MASB in the standard setting process and IFRS convergence discussions. In addition, the professional accounting bodies also educate its members by providing interpretations and guidance on the standards issued by MASB.

Furthermore, education attainment is fundamental to the development of all professions (DiMaggio and Powell, 1983). Previous researches find that members of professional bodies are motivated to fulfill their professional obligation required by professional bodies in order to maintain their professional status conferred through professional membership (Carpenter and Feroz, 2001; Touron, 2005). Carpenter and Feroz (2001) indicate that professional accounting associations exert normative pressures on US state governments' decision to switch from cash basic to accounting method based on GAAP. Thus, it is expected that finance and accounting staffs in company such as CFO, finance controllers, finance managers and accountants who are member of professional accounting bodies and participate actively in professional accounting bodies' activities such as attending training courses and seminars will be motivated and well prepared for IFRS convergence in 2012.

The degree of professionalization in the accounting practices is also influenced by the external auditors. Although external auditors do not impose preferred practices on clients, they may provide their opinions or suggestions on financial reporting practices. In addition, external auditors need to maintain their reputation and perceived quality of their works. Jones and Higgins (2006) indicate that external auditor is the most dominant party involved in the IFRS implementation process in Australia either as independent consultants assisting in the IFRS adoption process, or as the firm's auditor required to provide audit opinion on the financial statements.

There are some accounting literatures that support the influences of normative isomorphism on IFRS adoption. Parboteeah et al. (2002) indicate that the influence of accounting professional bodies has a greater impact on accounting practices than the national cultures of Japan and United States. Hassan (2008) and Irvine (2008) also argue that international accounting firms exert normative pressures on the IFRS adoption. Finally, Judge et al. (2010) demonstrate that normative isomorphism represented by education level within a nation is positively associated with IFRS adoption. Therefore, the third hypothesis is posited as follows:

H3: There is a positive association between the participation in accounting professional bodies and preparedness of companies for IFRS convergence.

2.6 Internal Barriers and IFRS Convergence

The previous sections discuss the external key drivers that influence the IFRS convergence based on institutional theory while this section looks at the internal barriers that may impede the implementation of IFRS from the resource-based view.

Resource-based view has been widely adopted in the strategic management researches. The resource-based view basically originates from Penrose (1959) seminal work that describe the firm as a bundle of resources. Penrose (1959) emphasizes that the growth of the firm is both facilitated and restricted by management ability to look for the best utilization of available resources (as cited in Bloch and Finch, 2010). This view is also articulated by Barney (1991) that indicates firm's specific resources and capabilities are the key factors of firm’s competitive advantage and performance (Barney, 1991). Thus, resources and capabilities are significant criteria for companies to move toward achieving certain goals and gain competitive advantages. From the resourced-based view, lack of resources and capability can be barriers for companies’ preparedness to move toward IFRS convergence. Hence, it is possible for this study to combine the institutional theory and resource-based view to explore the responses of companies for full convergence with IFRS in Malaysia.

In the process of IFRS convergence, countries and companies face challenges that shown by many empirical studies done especially in EU countries. Survey done by Larson and Street (2004) on IFRS convergence in 17 European countries identify that the most significant impediments to convergence are complicated nature of particular IFRS especially on financial instruments standard, tax-orientation of national accounting system, underdeveloped capital markets and lack of guidance. Jermakowicz and Gornick-Tomaszewski (2006) indicate that the IFRS implementation process in EU is costly, complex and burdensome. Further, Navarro-Garcia and Bastida (2010) provide empirical insights on Spanish publicly traded firms’ perceptions of IFRS and find that the adoption of IFRS is troublesome and failing to meet a cost-benefit trade-off in some cases. All these challenges may affect companies’ preparedness for IFRS convergence in Malaysia. In view of these challenges, it is crucial that companies assess their internal barriers that may influence their implementation of IFRS.

According to Hail et al. (2010), IFRS convergence has cost impacts to companies. One of the major costs is the transition costs for IFRS convergence. During the transition process of IFRS convergence, companies normally have to adjust their accounting system and process based on the new requirements of IFRS and regulations. Further, companies will also have to prepare at least one year of comparative prior period financial information based on IFRS 1 requirements. Training of human resources and communication to external stakeholders are also important implementation steps for IFRS convergence. Tokar (2005) argues that training of staff to understand new standards and developing IFRS-based resources to support professional working with IFRS are significant challenges. This view is supported by Jermakowicz and Gornick-Tomaszewski (2006) exploratory study done on 112 EU publicly traded companies that find IFRS adoption causes high cost of transition and tied up resources.

Jermakowicz and Gornick-Tomaszewski (2006) also investigate the obstacles faced by companies in implementing IFRS. The respondents of survey listed various obstacles and challenges that include complex nature of IFRS, lack of guidelines and interpretations, running of parallel accounting systems, preparation of comparative financial information for past years, lack of IFRS knowledge among staff, training of staff and changes of information system structure.

In Malaysia, Tan et al. (2006) conducted survey on the impact of FRS adoption in Malaysia in 2006 and indicated that the move towards implementation of FRS had an impact on the overall organization behaviors. The findings of survey reveal some major drawbacks or challenges in implementation process such as lack of communication to stakeholders, do not participate actively in consultancy process for standard setting, lack of staff competencies, training requirements, inadequate time to understand new standards and low dissemination of knowledge. These challenges or barriers cannot be overlooked by companies to ensure smooth transition to IFRS convergence.

To summarize, internal barriers such as lack of resources and capabilities may be obstacles for IFRS convergence. Thus, this study expects that internal barriers may impede companies' preparedness to IFRS convergence apart from the influences of external environment factors. The following last hypothesis is therefore proposed:

> *H4: There is a negative association between internal barriers and the preparedness of companies for IFRS convergence.*

2.7 Control Variables

Control variables are needed to take into account of other external factors that might influence the variables of interest or rule of explanation for any patterns. Based on the previous researches, we have identified the following two control variables: industry types and auditor types. Each of these variables is discussed below.

2.7.1 Industries Types

Differences among industries also seem to influence the degree of preparedness of companies for IFRS convergence. For companies in industries that are highly regulated, for example, finance institutes and insurance, the compliance level of financial statements will be primarily governed by regulatory practices. This is supported by Arena and Azzone (2007) that banking and insurance industry intend to set up internal audit department due to coercive pressures from the regulation forces in the industry. Chalmers and Godfrey (2004) also found a positive association for control variable of industry type represented by mining or oil activities and voluntary derivative financial instruments disclosures that required by accounting standard.

As the existing FRS framework is basically quite similar to the IFRS, MASB expects that the adoption IFRS-compliant FRS framework on 1 January 2012 would be similar to existing FRS framework with the exception of the plantation industry and possibly the real-estate industry and financial institutions. Therefore, plantation industry, real-estate industry and finance institutes would be expected to be more prepared for the IFRS convergence on the grounds that these industries are most likely to be affected by the new IFRS standards effective in 2012 onwards. For this study, a positive association is expected.

2.7.2 Auditor Types

Generally, Big 4 accounting firms serve audit clients across countries that have already adopted IFRS standards. It can be argue that an international network of Big 4 accounting firms helps to facilitate the sharing of common technical and operating standards, methodologies, training and technology that are related to IFRS adoption. Therefore, Big 4 accounting firms can help companies in the transition process to IFRS convergence

Empirical evidences support the role of international accounting firms on the adoption of IFRS. Prior research done by Street and Gray (2002) also find a significant association between the extent level of compliance with IFRS with U.S. or foreign exchange listing companies audited by large audit firms. Chalmers and Godfrey (2004) also show a significant association between voluntary reporting of derivative instruments and Big 6 auditors. Further, Guerreiro et al. (2008) point out that the level of preparedness of Portuguese companies to adopt IFRS is significantly associated with company audited by a Big 4 accounting firm. For that reasons, companies which use a Big 4 accounting firm to audit the financial statements are expected to adopt IFRS more easily and this helps them in the transition process of IFRS adoption. Thus, a positive association is expected.

2.8 Summary

Considerable studies and researches have been conducted to study the harmonization of international accounting standards and IFRS convergence. The present chapter provides an overview on the institutional theory, the application of institutional theory by looking specifically at the key influences of coercive, mimetic and normative isomorphism exerted on the convergence with IFRS as well as the internal barriers faced by organizations to adopt IFRS through the lens of resource-based view. The previous studies show that most of the past researches are conducted in the developed countries such as European Union, Australia and United States and there are very limited studies being done in Malaysia. In addition, the application of institutional theory is useful to study the IFRS convergence, but such a study, especially empirical work is very limited especially at the organization level. Hence, a gap has been identified and main research questions and motivations have been highlighted. This chapter leads us to the research frameworks and discussion of research methodology, which will be presented in the next chapter.