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Editors:
Ana Lorga da Silva, Tomislav Rados, Olga V. Kaurova

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CONTENTS

THE ROLE OF ENFORCEMENT MECHANISMS ON IFRS IMPLEMENTATION: PERCEPTIONS FROM TAX OFFICIALS

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ABSTRACT

The adoption of International Financial Reporting Standards (IFRS)-based accounting systems may not be enough to achieve global accounting harmonization. Prior studies shed light on the critical role played by enforcement mechanisms while effectively contributing to a worldwide adoption of IFRS. Nevertheless, there is a dearth of research on this topic that could bring to light opportunities to improve the effective implementation of IFRS-based models. This paper intends to reduce the gap of the research on this topic in Portugal by drawing conclusions from the perceptions of tax officials. This paper is a piece of qualitative longitudinal research since interviews were performed in two different moments: before adoption of an IFRS-based system, in 2009; and after adoption, in 2017. The findings of this study raise awareness towards a possible enduring and ongoing resistance to the implementation of the IFRS-based principles in Portugal, as a result of poor enforcement. Accordingly, this research suggests the need for drawing strategies to achieve the success of the Portuguese accounting reform, by effectively ensuring the financial reporting standards implementation, which ultimately may require the adoption of enforcement mechanisms.

Keywords: *Standards Enforcement, Longitudinal Research, International Financial Reporting Standards, Portugal, Perceptions, Tax officials*

1. INTRODUCTION

The adoption of International Financial Reporting Standards (IFRS)-based accounting systems may not be enough to achieve global accounting the material harmonization. There are plenty studies (e.g. Al-Shammari *et al.*, 2008; Al-Hussaini *et al.*, 2008; Bonetti *et al.*, 2016; Bradbury & Scott, 2020; Brown & Tarca, 2005; Carneiro *et al.*, 2017; Naser *et al.*, 2005; Quaglia *et al.*, 2020) highlighting the role of the enforcement as a perquisite to international financial reporting convergence of IFRS-based financial statements. From an institutional viewpoint (Oliver, 1991), enforcement structures are crucial to overcome resistance to change. Since the IASB does not have enforcement power, strong enforcement mechanisms become particularly relevant in promoting accounting quality following IFRS adoption (Soderstrom & Sun, 2007). Additionally, given the flexibility underlying IFRS standards, accounting professionals in Continental-European countries will follow general principles in contrast to the strict rules - based system they were committed to before (Ball, 2006).

In countries exhibiting a high level of shareholders protection, interpretation will tend to lead to a true and fair view of companies' reality. On the other hand, in countries marked by a strong protection of creditors, interpretation will be inclined to fulfill banks' contracting demands (Soderstrom & Sun, 2007). In what follows, effective enforcement mechanisms are paramount to effect global implementation of IFRS-based models. For instance, prior studies (e.g. Brown & Tarca, 2005; Daske *et al.*, 2013; Wang & Yu, 2015) suggest that the capital-market benefits around IFRS adoption are more likely to occur in countries with effective legal enforcement. While there is a growing body of IFRS-related literature, there is little research on IFRS enforcement (Bradbury & Scott, 2020). Such paucity is keenly felt in qualitative-based research. In this context, this study provides qualitative evidence on the appropriateness of enforcement mechanisms, from which measures are inferred to secure the success of the Portuguese accounting reform. To the best of our knowledge, there is no such study regarding Portugal (see for example, Oliveira *et al.*, 2018 for a review of the IFRS literature based on Portugal). This study is based on the perceptions of tax officials working with the external inspection of companies in Portugal. This is a piece of qualitative longitudinal research since interviews were performed in two different moments: before adoption of an IFRS-based system, in 2009; and after adoption, in 2017. In order to converge the national accounting standards with the EU-endorsed IFRS, the *Comissão de Normalização Contabilística* (CNC, the Portuguese Accounting Standards Board) approved a new Accounting Standards System, the *Sistema de Normalização Contabilística* (SNC, System of Accounting Standardization) of compulsory adoption by non-financial unlisted companies since 1 January 2010 (Decree-Law 158/2009 of July 13). SNC is generally aligned with IFRS (André, 2017; Isidro & Pais, 2017). Decree-Law (DL) authorized the SNC to establish penalties for non-compliance (DL 158/2009 Article 14, amended by DL 98/2015), with a view to promote compliance with this IFRS-based model. Accordingly, non-compliant companies are entitled to a penalty ranging from €1,500 to €30,000. The perceived incompatibility between the traditional Portuguese accounting system and IFRS philosophy is likely to hinder the effective national-level implementation of the IFRS model. Notably, this mismatch is likely to adversely influence receptiveness and acceptability of the IFRS ideology, and thereby compromise the quality of the resulting accounting information. Therefore, enforcement mechanisms are expected to play a particularly important role to the success of the Portuguese accounting reform, and, as such, this country provides a rich research setting of the core theme. The next section describes our research method. It is followed by the presentation of the research results. The final section discusses the main results and outlines their implications.

2. METHODOLOGY

The basic methodological underpinning of this research study is qualitative – rather than seeking to generalize the perceptions gained, the main objective of this study is to yield rich and detailed insights regarding IFRS' enforcement mechanisms (Miles & Huberman, 1994; Flick, 2006). A semi-structured interview guide was developed to obtain a balance between flexibility and comparability of the data collected. We selected one professional group whose perceptions of IFRS-adoption related issues remain under-researched: tax officials working with the external inspection of companies in Portugal. Although tax officials have been overlooked, they are well positioned to offer relevant insights since they deal closely with many preparers on their inspection practice, and they play a disciplinary role by seeking to ascertain financial statements' credibility. The first stage of the interviewing process took place in the first semester of 2009, when the Portuguese business community was in the stage of preparation for the adoption of the new accounting system in January 2010. The second round of interviews was later conducted seven years after adoption, in 2017. The interviewees were the same in both years of interviews.

Final sample size in each year is nine, and it was determined by the attainment of theoretical saturation (Strauss & Corbin, 1990; Marginson, 2004). Sampling of interviewees was non-probabilistic since simple random sampling is a poor way to draw a small sample (Maxwell, 1996). We wanted to potentiate extraction of highly relevant empirical evidence by interviewing mature professionals, who were still young enough to escape the possible age effect of being unfavourable to change processes as that underlying the research theme. In what follows, all but one of the sampled professionals had more than 15 years of working experience (n=8), and the dominant age group was 35-44. Reflecting a dominant professional trait, most interviewees were male (n=8).

3. RESULTS

Table 1 summarizes overall perceptions of interviewees regarding sufficiency or effectiveness of Portuguese enforcement mechanisms to ensure the consistent application of the IFRS- based accounting standards.

Table 1: Perceptions of enforcement mechanisms to the IFRS-based model

	Year of interviews	Insufficient / Ineffective	Undecided	Sufficient / Effective
Tax Officials (n=9)	2009	9	0	0
	2017	9	0	0

Both just prior adoption and seven years after adoption of the IFRS-based model, all Tax Officials (TO) perceived extant Portuguese enforcement mechanisms to be unsuitable to ensure proper application of the new accounting model. Outstandingly, the minority of respondents who perceived extant enforcement mechanisms to suffice, acknowledged some caveats as to their effectiveness. On debating the issue of enforcement, a wide majority of interviewees proved extremely critical, either in 2009 or 2017. It is remarkable that gist perceptions on insufficiency or ineffectiveness of enforcement mechanisms were maintained over the years, which is consistent with enforcement not being a short-time bridgeable obstacle to the development of a country's accounting system. As early as prior to adoption, in 2009, enforcement was perceived to be a weapon to offset the potential threats posed by the national institutional context. By decreasing order of citation, such threats related to the accounting profession, the accounting culture, and the tax-accounting relationship. For instance, some respondents already anticipated that the shift on traditional cultural values and the disengagement between accounting and taxation underlying the implementation of the new accounting model demanded enhanced supervision. Yet, strengthening of supervision was mostly perceived in 2017 not to have, at least satisfactorily, occurred. Major criticisms to enforcement made in 2009 were the excessive long processes, the lack of coordination among enforcement authorities, and the inexistence of penalizations for non-compliance. However, it should be noted that in 2009 the CNC's enforcement system (art. 14, DL 158/2009) - namely the penalties measures resulting from the non-application of the SNC – had not yet been announced, and therefore, they were unknown to the respondents. Nevertheless, seven years after having been implemented, interviewees were unanimous in acknowledging the CNC's enforcement system not to be in place, which was attributed to "*CNC's shortage of human resources to carry out inspections*" (TO7, 2017). In the wording of one TO, "*When this enforcement system was created and announced, accountants feared it, but now they have realized nothing has happened to date, so they are very much laid-back toward accounting practice*" (TO3, 2017). It was underlined that "*It is important to bring CNC's enforcement system to operate in order to uncover the extent of actual adherence to SNC's standards*" (TO7, 2017). Additionally, several interviewees (TO1, TO2, TO7, 2017) were critical of the auditors' enforcement role.

They acknowledged that in so far as auditors are paid by their clients, there is no true independence, so their certifications of financial statements are distrustful:

The relevance we [TO, in inspection practice] *give to a legal certification of accounts is truly little. From the experience we have, we already came to the conclusion that there are many flaws at the accounting level, which sometimes actually have major implications, namely in terms of continuity, and they are too often omitted by auditors. (TO7, 2009)*

I do not believe statutory auditors very much (…) actually, they are the first ones to carry out abusive tax planning to justify the large amounts they earn (…) Their work is not one of independence. (TO2, 2017)

(…) there is something that puzzles me: if the largest corrections forced by tax authorities correspond with erroneous accounting situations, mostly occurred in large firms (…) how come that according to the corresponding Audit Certificates on the Financial Statements there was a true and fair view?! (…) I am sure problems are spotted, but they are not reported because of economic dependency considerations. (TO1, 2017)

To overcome auditors' alleged independence problem, it was suggested "*External auditors should not be freely selected and hired by the companies themselves*" (TO1, 2009) because "*As long as there is a dependency relationship, if the auditor doesn't do what the client says, the client will tell he/she will hire another auditor*" (TO1, 2009). Some TO admitted being, to a greater or lesser extent, unfamiliar with the process and effectiveness of the random quality control carried out by OCC (*Ordem dos Contabilistas Certificados*, i.e. Portuguese Chartered Accountants). Yet, the dominant view of interviewees (TO2, TO6, TO7, TO8, TO9, 2017) was that OCC's enforcement mechanism was ineffective. This was corroborated by quotations such as the following:

Many accountants are highly fraudulent (…) I see accountants that are in the market and given the batch of frauds they commit, they should no longer be accredited (…) and there is no culture of denouncing these people and little culture of OCC kicking out these people (…) this culture of denouncing should be stimulated by OCC. (TO2, 2017)

The enforcement measures suggested by the interviewees include the following: (i) discuss the way the supervision is being exercised and regulated (importance of the supervisors to correctly interpret their mission); (ii) profession-wide quality assurance; (iii) reinforce preparers' responsibilities; (iv) change the way the auditing activity is regulated (change the relationship between auditors and their clients); and (v) increase the spectrum of companies subject to auditing. As to the later suggestion, some interviewees raised concerns with its feasibility because "*…if companies have to pay for supervisory mechanisms, it is not affordable... already many companies required to have external auditing, do not actually have it because they cannot afford to pay to an auditor*" (TO2, 2009).

4. DISCUSSION AND CONCLUSIONS

In both interview stages (2009, 2017), tax officials perceive extant enforcement structures to be inefficient to ensure the success of the Portuguese accounting reform. Such longitudinal finding suggests poor enforcement may not be a short-time bridgeable obstacle to the development of a country's accounting system. In what follows, our evidence raises serious concerns regarding the adverse effect of the environmental factor *enforcement* on the occurrence of resistance to adoption of the IFRS-based accounting system in Portugal.

This point is particularly critical in the Portuguese context, given the *a priori* unfavourable institutional context. Despite tax officials' acknowledgment of auditors' enforcement role, some suspicion of their professional independence emerged. It was suggested auditors be allocated to companies by an independent third party. This is in line with Bradbury and Scott (2020, p.18) who suggested "*private enforcement (auditing) and public enforcement (regulation) are complementary activities*". While it was emphasized the need for enforcement measures to secure the success of the accounting reform, tax officials were highly critical of the Portuguese government's policy initiatives to improve supervision, namely the enforcement system established by the CNC. Particularly, it was suggested that this enforcement system should be put into operation. Arguably, failure to implement this may lead preparers to engage in decoupling. Other opportunities for improvement were uncovered, namely a broader and more stringent control exerted by OCC, in addition to other possible enforcement measures suggested by interviewees, as described earlier. Overall, our results corroborate Brown & Tarca's (2005) interview study, which pointed to the need to modify the roles of national enforcement bodies and standard setters following IFRS adoption. From an institutional viewpoint, this evidence corroborates Oliver's (1991) argument on the critical role of enforcement mechanisms to surpass resistance to change. The emergent evidence is also in line with many findings of prior literature reporting the enforcement of IFRS-based financial statements as a perquisite for the international financial reporting harmonization. In view of the above, it might be claimed that enforcement is a key element of the IFRS-based financial reporting framework. As acknowledged by interviewees, sufficient and effective enforcement is important to assist overcoming institutional barriers to the success of the accounting reform. Therefore, failure to undertake the recommended strategies might generate adverse consequences for the implementation of the new accounting system, such as: the decoupling - namely, the maintenance of the prudence and secrecy cultural traits, and the linkage between taxation and accounting. Concurrently, our research evidence may assist national and international regulators, namely the IASB, the CNC, and the OCC, to pursuit sufficient and effective enforcement mechanisms. Our findings also lend support to Quagli *et al.*'s (2020) conclusion about the opportunity of establishing a European Union (EU) supranational IFRS enforcer.

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