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What determines the impact of mandatory IFRS adoption?

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Based on two papers co-authored with
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Presentation overview

- The idea: Economic consequences are heterogeneously distributed among firms

- Paper 1:

  Cross-sectional variation in the economic consequences of international accounting harmonization: The case of mandatory IFRS adoption in the UK

- Paper 2:

  Incentives or standards: What determines the quality changes around IFRS adoption?

- Implications and conclusion

Idea

- IFRS is principle based like most accounting standards
  - Choice between valuation methods (e.g., historical cost/fair value or depreciation method) and to some extent recognition (e.g., development or leasing)
  - IFRS developed to suit firms from many different countries and industries
  - It is unlikely that IFRS per se can change much
- When given the choice not all firms choose IFRS
  - The choice varies systematically with size, financial structure, and foreign exposure
  - Perhaps net benefits also vary among firms!

Paper 1: Mandatory IFRS in the UK

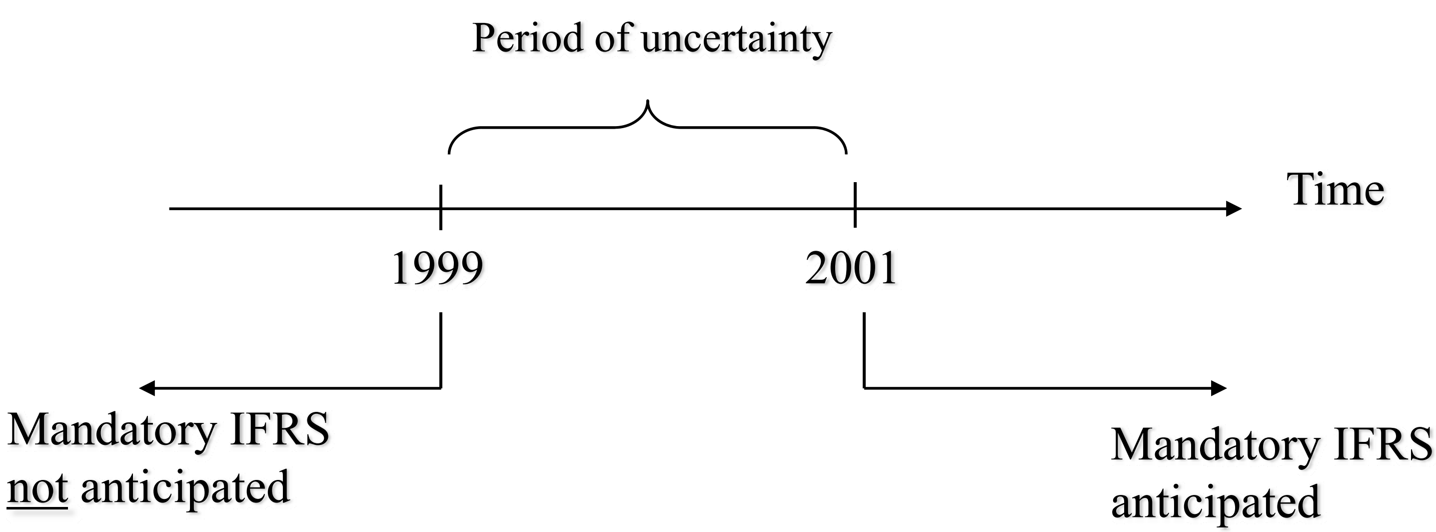
- *Cross-sectional variation in the economic consequences of international accounting harmonization: The case of mandatory IFRS adoption in the UK*
- Using data from before mandatory IFRS adoption (2004 and before)
- In Germany, voluntary adoption of IFRS is allowed as alternative to local GAAP and this practice is common
- In the UK, IFRS adoption is only allowed as dual reporting and the practice is very uncommon

Paper 1: Willingness to adopt

- We model (logit) the choice to voluntarily adopt IFRS in Germany as a function of
  - Size
  - Financial structure
  - Foreign exposure
- Use this model to estimate UK firms' willingness to adopt IFRS (i.e., incentives)
- Construct firm specific measure of their willingness to adopt (between 0 and 1)

Paper 1: Economic consequences

- We exploit the assumption that an informationally efficient market reacts to anticipated benefits prior to actual IFRS adoption
  - Market reactions to public announcements (events in 1999 and 2000)
  - Changes in implied cost of capital from before uncertainty (1999) to after uncertainty (2001)



Market reactions to public announcements of mandatory IFRS

Events	Dates	Market reaction
1	28-01-1999	0.011**
2	22-03-2000	0.014**
3	18-05-2000	0.012
4	09-06-2000	0.005
5	13-06-2000	-0.003
6	17-07-2000	0.007**
7	27-11-2000	-0.003
Net	All events	0.007**

- Sefcik and Thomson (1986) portfolio approach
- Market reactions strongest in the beginning
- Net effect positive and significant
- Conclusion:

  Firms with a higher willingness to adopt experience positive (negative) market reactions to announcements that increase (decrease) the likelihood of mandatory IFRS.

Changes in the implied cost of capital in anticipation of IFRS

Independent variables	Coefficients	Coefficients
Willingness to adopt	-0.098**	-0.098**
Pr*US		0.15**
ΔMV	-0.526**	-0.513**
ΔBM	-0.018	-0.014
ΔDTM	0.031**	0.032**
ΔSG	0.000	0.000
ΔOPM	0.000	0.000
Intercept	0.074	0.072
US		-0.065

- Dependent variable: Implied cost of capital (OJ and PEG models)
- Negative correlation between the willingness to adopt IFRS (Pr) and the implied cost of capital
- Except if the firm is cross-listed in the US
- Conclusion:

  Firms with a higher willingness to adopt experience a relative reduction in the implied cost of capital after IFRS became mandatory.

Paper 2: Voluntary / Mandatory adoption in Germany

- *Incentives or standards: What determines accounting quality changes around IFRS adoption?*
- Prior literature document accounting quality improvements around voluntary IFRS adoption
- Voluntary adoption in a year of change:
  - More external financing
  - More investments
  - More analyst following
- Is voluntary IFRS adoption a correlated outcome or the source of these changes?

Paper 2: Setting

- IFRS allowed instead of HGB (=local GAAP) in consolidated statements since 1998 and adoption became mandatory in 2005
- Voluntary adopters perceive net benefits of IFRS (i.e., have incentives to adopt)
- Firms that resist until IFRS became mandatory perceive no benefits of IFRS (i.e., have no incentives to adopt)
  - Voluntary adopters 59% (Perceive benefits)
  - Resisters 41% (Perceive no benefits)

Changes in the properties of earnings around voluntary adoption

	Pre IFRS	Post IFRS	Sign.
Obs.	357	699	
Var(NI*)	0.003	0.004	**
Var(NI*) / Var(CF*)	0.480	0.982	**
Cor(ACC*, CF*)	-0.67	-0.55	**
Small profits	-0.766		No

- Increased variability of net income
- Not driven by cash flows
- Correlation between accruals and cash flows reduced
- Less small profits
- Conclusion:

  All consistent with less earnings management

Changes in timely loss recognition around voluntary adoption

	Pre IFRS	Post IFRS	Sign.
Obs. (min.)	551	676	
Basu cons.	0.11	0.21	*
Loss persist.	-0.24	-0.78	**
Large losses	0.3643		No

- Increased timeliness of losses
- Decreased persistence of losses
- More large losses recognized
- <u>Conclusion:</u>

  All consistent with more timely loss recognition

Changes in the properties of earnings around Resisters' forced adoption

	Pre IFRS	Post IFRS	Sign.
Obs.	904	283	
Var(NI*)	0.007	0.004	**
Var(NI*) / Var(CF*)	0.969	0.899	No
Cor(ACC*, CF*)	-0.55	-0.49	No
Small profits	0.396		**

- Decreased variability of net income
- Driven by cash flows
- Correlation between accruals and cash flows marginally reduced
- More small profits
- Conclusion:

  Mixed results generally pointing toward more earnings management

Changes in timely loss recognition around Resisters' forced adoption

	Pre IFRS	Post IFRS	Sign.
Obs. (min)	1331	289	
Basu cons.	0.35	0.12	**
Loss persist.	-0.42	-0.44	No
Large losses	-0.8680		**

- Decreased timeliness of losses
- No change in the persistency of losses
- Less large losses recognized
- <u>Conclusion:</u>

  All findings consistent with no change or less timely loss recognition

Conclusion and implications

- Economic consequences vary among firms and the variation is related to firms' willingness to adopt (= incentives)

- IFRS per se does not change the properties of accruals or market based outcomes

- Implication:
  - IFRS is neither good nor bad and it is what firms make it.
  - We cannot improve accounting quality simply by mandating what is perceived to be higher quality standards because firms without incentives to adopt are unlikely to respond by improving accounting quality.