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The impact of national GAAP and accounting traditions on IFRS policy selection: Evidence from Germany and the UK

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ABSTRACT

The adoption of IFRS in the European Union in 2005 aimed to increase the comparability of publicly traded companies' consolidated accounts. However, previous literature questions whether IFRS are applied consistently across countries with differing institutional environments, and therefore, whether *de facto* harmony has been achieved. We further examine this question by investigating IFRS accounting policy choices of listed companies in Germany and the UK between 2005 and 2009. We find that most firms, when choosing IFRS options, tend to retain accounting policies required by national rules. We also investigate national accounting traditions in the case of options under national GAAP and find that most companies continue these after adopting IFRS. Moreover, there appears to be little significant change in accounting choices over time from 2005 to 2009. Given the differences in accounting rules and practices that exist across countries, our results suggest that international differences in financial reporting are likely to continue under IFRS.

1. Introduction

The requirement that European Union (EU) listed companies prepare their consolidated accounts using International Financial Reporting Standards (IFRS) beginning in 2005 effectively mandated the use of identical accounting standards across European borders for the first time. However, IFRS provides companies with some flexibility in application, given the explicit and implicit options contained in the standards, discretion in interpretations, and need for estimations. Consequently, the application of IFRS may vary from one firm to another, or from one country to another. Hence, it is questionable whether IFRS are applied consistently, i.e. whether the harmonization of accounting rules in the EU also has led to harmonized accounting practices.

Nobes (2006) and others suggest that country-specific factors may influence IFRS consolidated reporting. This paper addresses this question by investigating the potential impact of country specific factors on IFRS application in Germany and the UK. Our paper extends the IFRS application literature by examining a large sample of German and UK firms where national generally accepted accounting principles (GAAP) provide management with financial reporting options. We find that in most cases sample companies not only continue under IFRS with policies required by national GAAP, but continue with those reporting options that were predominantly chosen under national GAAP.

The remainder of this paper is organized as follows. Section 2 provides background information on international differences in accounting regimes and reasons why country-specific factors may have an influence on the application of IFRS in consolidated statements. Section 3 reviews prior research associated with national versions of IFRS practice. Then, Section 4 introduces our research design. Section 5 discusses our first-step analysis including a description of the sample and data as

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well as our findings of national rules and practice under national GAAP. The development of the hypotheses underlying our study is dealt with in Section 6. In this section, we integrate the results of our first-step empirical analysis that are important to build the hypotheses. Section 7 presents the sample and data as well as the results of our second-step empirical analysis. Finally, Section 8 provides our conclusion.

2. Background

2.1. Differences in national accounting systems

The factors affecting the development of national accounting systems are numerous and varied ranging from financing sources, legal and tax systems, and culture to significant periodic economic and market events like inflation or recession (Gray, 1988; Roberts, Weetman, & Gordon, 2008; Saudagaran, 2009). To facilitate the understanding of accounting systems, classifications have been adopted which group countries with similar rules and practices (e.g. AAA, 1977; Nair & Frank, 1980; Nobes, 1998). This allows one to distinguish between the Continental-European (e.g. Germany, France and Italy) and the Anglo-Saxon accounting systems (e.g. UK, USA and Australia) (Nobes, 1998). The first group is characterized by credit-based financing, a close connection between financial and tax accounting, and codified accounting rules. The second group is distinguished by its capital market financing, separation of financial and tax accounting, and accounting rules developed by private standard setting bodies (Flower, 2002; Roberts et al., 2008).

When analyzing differences in accounting and harmonization, it is important to distinguish between accounting rules and accounting practice. Therefore, in this study, any reference to national GAAP includes codified rules as well as non-codified principles, standards and norms on a national level that have to be observed when a company's financial statements are compiled (Leuz & Wüstemann, 2004). In contrast, by accounting practice, we mean financial statements as the outcome of accounting, which embraces, apart from the national GAAP amongst others, the accounting policy choices made by companies. Any activities to reduce differences on either the national GAAP or practice levels have been labelled as *de jure* and *de facto* harmonization (van der Tas, 1992). In the past, several studies have found not only large cross-country differences in accounting rules, but also in the application of those rules (e.g. Price Waterhouse, 1973; Simmonds & Azières, 1989).

2.2. The survival of country-specific practices when applying IFRS

Why should country-specific factors influence the application of IFRS in consolidated accounts? Several reasons may explain why this might occur.

First of all, if separate company accounts still must be maintained under a country's national GAAP (e.g. in Germany for distribution and tax purposes) or are still prepared by choice (e.g. as possible in the UK), accounting decisions based on a country's unique national standards may well be retained in the consolidated accounts as long as they comply with IFRS. This is relevant both if national GAAP requires a specific accounting procedure, or national GAAP allows a choice between several possible policies. In both cases, the policy adopted under national GAAP would likely be retained for reasons of cost and efficiency (Gee, Haller, & Nobes, 2010; Kvaal & Nobes, 2010).

Another reason for retaining accounting decisions under national GAAP in IFRS reporting might be to reduce differences between consolidated financial and tax accounts as long as measurement issues could affect pre-tax profit (Rammert, 2010). For example, companies might find it difficult to explain to tax officials why identical transactions were treated differently in two different sets of accounts. Moreover, minimizing differences between both financial and tax accounts may reduce differences leading to deferred taxes, thereby further reducing efforts and costs associated with the financial reporting of income taxes (Gee et al., 2010). Additionally, especially for the UK, it would be difficult to justify abandoning national GAAP, if IFRS permitted a similar treatment that would give a true and fair view (UK GAAP), or a fair presentation (IFRS) of the company's affairs (FRS 18.17, IAS 1.15–18 and IAS 8.14).

The application of IFRS also may be driven by national GAAP because of inertia or the desire to minimize changes in financial reporting for personnel or external stakeholders caused by switching from one set of accounting rules to another (Nobes, 2006). This means that national accounting traditions (i.e. accounting choices under national GAAP), may be retained under IFRS consolidated reporting even if a company has switched to IFRS in its individual accounts.

Finally, a company's desire to ensure consistency in financial reporting may play a role in retaining methods previously chosen under national GAAP. The consistency principle might be less relevant when switching from one set of accounting rules to another (e.g. from German or UK GAAP to IFRS) than when preparing financial statements at two given points in time using the same accounting rules. However, having a choice of different accounting methods, firms might choose to be persistent in the accounting methods used in order to deliver financial information to interested parties that is most comparable over time (McCosh, 1967).

Conversely, firms may choose to abandon their national accounting traditions when reporting under IFRS. For example, companies might use methods that have broader acceptance internationally to increase comparability with competitors. They also might change accounting policy to meet expectations of international capital market actors that prefer specific accounting methods, mostly again for the sake of comparability. Additionally, firms may change accounting policies because they believe that particular IFRS specific methods more adequately provide a true and fair view, or when IFRS offer an