Accounting Forum 40 (2016) 45–62

Contents lists available at ScienceDirect

Accounting Forum

journal homepage: www.elsevier.com/locate/accfor

Impact of international financial reporting standards on the profit and equity of AIM listed companies in the UK

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ARTICLE INFO

Article history:
Received 27 January 2015
Received in revised form
10 November 2015
Accepted 8 December 2015
Available online 30 December 2015

Keywords:
International financial reporting standards
Accounting harmonisation
Alternative investment market
Small and growing companies
Gray conservatism index
IFRS 1

ABSTRACT

This study examines the extent to which the change from UK GAAP to IFRS has affected companies listed on the Alternative Investment Market (AIM) in the UK. The results suggest that, on average, profit reported under IFRS is higher than that reported under UK GAAP; however, the difference is much smaller for AIM listed companies as compared to what existing literature suggests for firms listed on main stock markets. The Gray's partial analysis results indicate that despite the extensive programmes for improving convergence over time there is still a considerable discrepancy between IFRS and UK GAAP.

1. Introduction

The introduction of International Financial Reporting Standards (IFRS) has received significant attention in both academic and non-academic literature. At the global stage, these standards have become the most common set of financial reporting regulations, as more than 120 countries use, or have permitted the use of IFRS for public reporting purposes (IASplus, 2011). The move towards the worldwide recognition of IFRS led the European Union (EU) to pass a regulation in 2002, which requires all companies with securities listed on EU Stock Exchanges to comply with IFRS in preparing their consolidated financial statements from January 2005. As a result, it became obligatory for all UK companies, listed on the main London Stock Exchange (LSE), to follow IFRS with effect from January 2005. At the same time while adopting IFRS, the UK Accounting Standards Board (ASB) on the recommendation of LSE, delayed its implementation for AIM listed companies to January 2007. However, AIM listed companies were given the option of adopting IFRS on voluntary basis with effect from January 2005.

Alternative investment market has been a vital source of capital for a wide range of companies. Since its establishment in 1995, it has experienced continuous growth and has attracted both domestic and foreign investors. By the end of 2014, over 3500 companies have used this market for raising over £90 billion for inspiring their operations and growth (LSE, 2015). Thus by considering the key characteristics of AIM companies, such as size, listing requirements, governance structure, and investor base, we argue that a change from UK GAAP to IFRS has implications for these companies. Furthermore, UK has maintained sophisticated accounting standards for several decades, and as IFRS are largely principle-based rules, where

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http://dx.doi.org/10.1016/j.accfor.2015.12.001
0155-9982/

there is an element of flexibility and judgement in the interpretation and application of certain standards, an impact on UK companies is expected. We therefore explore whether and how the adoption of IFRS has influenced the profit and equity of AIM listed companies.

In this regard, evidence in the existing literature indicates that professional judgement in the interpretation of various principles of accounting are partly influenced by a number of factors such as, culture, education, training, legal and governance systems (see e.g., Chesley, 1986; Doupnik & Richter, 2003; Doupnik & Riccio, 2006; Chand, Cummings, & Patel, 2012). As a consequence, a number of studies apply the Hofstede (1980) dimensions of culture and the subsequent application of these to accounting by Gray (1988). Most of such studies, examine variation in the application of financial reporting regulation across different countries and organisations suggesting that cultural differences across nations would have a bearing on the interpretation of regulation and the financial reporting practices of firms (see e.g., Radebaugh & Gray, 2002; Nobes & Parker, 2012). Similarly, in the context of IFRS adoption and its consequences, Brown and Tarca (2005) argue that variation in culture may affect the manner in which IFRS are used. In addition, Chand et al. (2012) pinpoint the need for regulators to consider cultural factors and argue that an absence of consensus about the numerical meaning of uncertainty expressions in IFRS is likely to lead to inconsistency in the use of accounting standards across different cultures.

It is therefore argued that before implementing a change in accounting system, regulators and policy makers have to bear in mind the key elements of culture identified by Hofstede (1980)[1]. This is because it is expected that those countries and cultures which are characterised by collectivism and secrecy (such as China, India, Japan, and many other developing countries) would exhibit higher degree of power distance and uncertainty avoidance, as compared to other cultures (such as US, UK, and Australia) that would largely demonstrate traits of individualism and masculinity. It has also been argued by researchers that preparers of accounts from a jurisdiction depicting secrecy (more conservative) will use higher probability threshold in recognising assets and other items that result in higher income, and a lower probability limit for the recognition of obligations and transactions that reduce profit (e.g., Doupnik & Riccio, 2006; Chand et al., 2012). As a consequence, we empirically test as to how the transition from UK GAAP to IFRS has affected the profit and equity of AIM listed companies.

The first-time adoption of IFRS (IFRS 1) was issued in June 2003 for facilitating the transparency of the impact of the IFRS adoption process. It requires disclosure of profit and equity under both the new and old regulations. It also requires that 'an entity shall explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance, and cash flows' and should also report a statement showing a reconciliation of the financial statements that resulted from the change in regulation. Thus IFRS 1 adoption provides an opportunity to measure the impact of the change, not just in one accounting standard, as would normally be the case with regulatory change, but for the entire range of accounting standards as it provides controlled and reliable data to evaluate the impact of the introduction of IFRS on profit and equity of AIM listed companies in the year of transition. In addition, EC Regulation No. 1606/2002 is considered as one of the most significant changes in European financial reporting history and given that this regulation is of much significance to the UK[2], it will be appropriate to argue that until now few studies have focused on the UK's experiences with the new financial reporting standards. This paper therefore examines the transition to IFRS of the UK based companies, listed on AIM by analysing the reconciliation disclosures required under IFRS 1 and contributes to the existing literature as follows.

First, we concentrate only on AIM listed companies which have never been investigated before with respect to the implications of IFRS and given the importance of AIM as an alternative market in the UK, we argue that this will be a useful contribution to the literature. In addition, AIM listed companies are different from companies listed on the main LSE due to their size, listing requirements, governance structure, and investor base and thus need a detailed investigation with respect to the adoption of IFRS. Second, under the framework of positive accounting theory[3], we assume that managers of firms will adopt accounting policy choices to enhance their self-interest with respect to the disclosure of profit and equity under IFRS 1. Additionally, most of the previously published studies in this area have either focussed on individual companies' accounting policy choice or on companies in general, by responding to a change in a single accounting standard with a relatively narrow focus on the change in reported profit and equity of companies. Our study takes advantage of the IFRS adoption by many companies, and for all accounting standards, simultaneously, and investigates accounting policy implementation and choice across a broad spectrum. This investigation considers both the compulsory and voluntary adopters of IFRS. In addition, IFRS 1 disclosures provides an opportunity for measuring the impact of change, for an entire range of accounting standards at a

[1] Hofstede (1980) identifies four different dimensions of culture as; power distance, individualism, uncertainty avoidance, and masculinity. Under this framework, power distance is interpreted as gauging the level of equality or the lack thereof in power distribution across institutions and organizations. Similarly, uncertainly avoidance relates to whether people in a society attempt to manage the future by planning minute details without any flexibility or go with the tide. According to Hofstede, societies with high uncertainty avoidance have rules, standardized procedures, and formal organizational structures with little flexibility and tolerance to accommodate behaviours and opinions that differ from their own. In addition, individualism refers the extent to which individuals are integrated into groups. Individualistic societies typically depict the attributes of people concerned with themselves rather than the groups to which they may belong. Finally, the masculinity dimension of culture explores the extent to which there is a preference for success, heroism, achievement, and assertiveness in society. Based on Hofstede's framework, UK for instance, would typically be characterized by a high index value for individuality and masculinity, while a lower value for power distance and uncertainly avoidance dimensions.

[2] Over the years UK has maintained sophisticated financial reporting standards with the largest capital market in the European Union.

[3] Under the assumptions of Positive Accounting Theory, managers of firms will adopt certain accounting methods for self-interest (Watts & Zimmerman, 1978).