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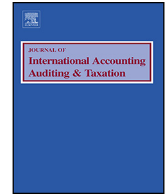

Does mandatory IFRS adoption improve information quality in low investor protection countries?

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ABSTRACT

We examine the effect of mandatory IFRS adoption on the information quality of financial reporting in France, Germany and Sweden. These three Western European civil law countries are characterized as low investor protection by the World Economic Forum's 2012/2013 Global Competitiveness Report. Using data for 2003 and 2011, we find significant improvement in both forecast accuracy and forecast dispersion following mandatory IFRS adoption in all three countries. Furthermore, the effect on information quality is greater the lower the strength of investor protection. These results suggest that mandatory IFRS adoption in low investor protection countries leads to an improvement in information quality. A tentative implication of the results is that standard setters should not delay IFRS adoption pending regulators implementing a high investor protection.

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1. Introduction

The International Accounting Standards Board[1] (IASB) develops International Financial Reporting Standards (IFRS) with the aim of unifying capital markets under one common reporting language (Ball, 2006). With implementation of International Accounting Standards (IASs) and more recently, IFRS, the IASB seeks uniform high quality financial reporting across the world (Ball, 2006). This study examines the effects of IFRS adoption[2] on information quality in France, Germany and Sweden.

Daske, Hail, Leuz, & Verdi (2008) find that mandatory IFRS adoption has a positive effect on capital markets, but only in countries with relatively high investor protection. These results are supported by Jiao, Koning, Mertens, and Roosenboom (2012) and Horton, Serafeim, and Serafeim (2013). The meta-study by Ahmed, Chalmers, and Khlif (2013) finds an overall positive effect from IFRS adoption. In contrast, Ahmed, Neel, and Wang (2013) find that accounting quality decreases with adoption of principle-based IFRS, as opposed to more common rule-based domestic GAAPs. Jeanjean and Stolowy (2008) find little effect on Australian and United Kingdom firms, but discover increased earnings management in French firms.

We reexamine the effect of mandatory IFRS adoption in low investor protection countries. We use data from France, Germany and Sweden as these countries are characterized as low investor protection countries by the World Economic Forum's 2012/13 Global Competitiveness Report (GCR), and in studies by La Porta, Lopez-de-Silanes, Shleifer, and Vishny

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[1] The International Accounting Standards Board (IASB) was formerly known as the International Accounting Standards Committee (IASC). For simplicity, in this report we use only the name 'IASB' in reference to both organizations during their respective periods of governance.

[2] Prior to 2001, standards created by the IASB were called International Accounting Standards. IFRS incorporates all IASs. For simplicity, we use the term 'IFRS' throughout the text.

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(1998), Daske et al. (2008) and Jaggi and Low (2009). These countries are characterized as low investor protection primarily due to their civil law[3] legal origins (La Porta et al., 1998).

As in Jiao et al. (2012) and Horton et al. (2013), we use analysts' forecast errors and forecast dispersion to gauge the effect of IFRS on the information environment. We find significant improvement in both forecast accuracy and forecast dispersion following mandatory IFRS adoption. Furthermore, the effect on information quality is greater the lower the strength of investor protection. We control for industry and country effects and our results are robust to increasing the sample size, matched sample, and removing financial companies from the primary sample.

Daske et al. (2008) examines only 2005, the year of mandatory adoption, and Ahmed, Neel, et al. (2013) incorporate only two years of post-adoption data. However, the effects of IFRS adoption may not be seen until later years (Ball, 2006). Ball (2006) suggests that IFRS creates a one-time cost for analysts to learn the new standards, thus analysts are left without a significant frame of reference or history of IFRS statements for at least a few years. Therefore, although analyst forecast accuracy and forecast dispersion may improve in the long run due to IFRS adoption, they are likely to display little change in the years immediately following adoption. Our data covers the period 2003–2011. Therefore, we utilize the most recent and complete available data to avoid bias in forecast accuracy created by a lack of IFRS history.

Our study makes several important contributions to existing literature. First, our study is concerned only with mandatory IFRS adoption, thus excluding voluntary adoption. In contrast, Ahmed, Chalmers, et al. (2013) examine the effects of both mandatory and voluntary adoption. Second, our study includes only low investor protection countries. In contrast, Daske et al. (2008) and Ahmed, Neel, et al. (2013) include both high and low investor protection countries. Finally, we examine three countries from three different civil law backgrounds. As the level of investor protection in a country is primarily characterized by its legal system, this allows us to examine the relative effects of mandatory IFRS adoption in each of the three main civil law traditions, German, French and Scandinavian (La Porta et al., 1998).

The rest of this paper is organized as follows: Section 2 reviews previous literature, and provides a background for the direction of this study. Section 3 develops hypotheses. Section 4 illustrates and explains the research design. Section 5 presents empirical results and Section 6 concludes our study.

2. Background and literature review

2.1. IFRS

With over 120 countries worldwide either requiring or permitting the use of IFRS for financial reporting, there has been a significant global shift from traditional cost-based accounting towards fair-value accounting (Horton et al., 2013; IFRS Foundation, 2013a; Reisloh, 2011). With China having substantially converged its national standards to IFRS, Canada having adopted IFRS for all listed entities in 2011, and India committing to convergence, IFRS is gaining a global stronghold (IFRS Foundation, 2013a, 2013b).

Advocates of IFRS argue that these standards provide more relevant information for investment decisions, as they allow for measurement and recognition of transactions that better represent the economic reality of a firm (Barth, Landsman, & Lang, 2008; Firth, Gounopoulos, & Pulm, 2012). Furthermore, IFRS provides international comparability in financial reporting, which proponents argue improves analysts' forecast accuracy and improves the basis for investment decisions (Barth et al., 2008; Daske et al., 2008; Firth et al., 2012; Horton et al., 2013; Yeng & Henry, 2013).

Proponents further suggest that with improved comparability of firms across markets, IFRS makes it easier and less costly for investors to compare firms in which they may consider investing (Armstrong, Barth, Jagolinzer, & Riedl, 2010; Covrig, DeFond, & Hung, 2007; Daske et al., 2008). Increased comparability is primarily the result of a decrease in discretionary accounting rules included in IFRS (Barth et al., 2008; Bissessur & Hodgson, 2012; Ding, Jeanjean, & Stolowy, 2009). The effect of adoption on firms domiciled in countries with traditional standards similar to that of IFRS is expected to be small (Ashbaugh & Pincus, 2001; Byard, Li and Yu, 2011; Horton et al., 2013; Yeng and Henry, 2013). However, even though improvements in the quality of financial information reported after IFRS adoption may be negligible or non-existent, increased comparability may lead to greater cross-country information for investors and thus increased investment (Daske et al., 2008).

Recent studies suggest that the role of accounting standards in financial reporting is limited, and that firms' incentives are a much greater determinant of the quality of reporting (Ball & Shivkumar, 2005; Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003; Burgstahler, Hail, & Leuz, 2006; Christensen, Lee, & Walker, 2008; Daske et al., 2008; Jeanjean & Stolowy, 2008; Leuz, 2003). Many argue that the application of financial reporting standards involves considerable judgement, regardless of the standards applied (Daske et al., 2008; Jeanjean & Stolowy, 2008). Further, IFRS is based on the concept of fair-value accounting, leading to greater discretion and subjective judgement by accountants than in the traditional GAAP of most countries (IFRS Foundation, 2013a). Therefore, prior research suggests that the quality of financial reporting is directly correlated to firms' incentives to report opportunistically (Daske et al., 2008).

Daske et al. (2008; p. 1094) suggest that, ceteris paribus, countries with "stricter enforcement regimes and institutional structures that provide strong reporting incentives are more likely to exhibit discernible capital-market effects around

[3] The term 'civil law', used by La Porta et al. (1998) is interchangeable with the term 'code law' which (put most simply) refers to the greater emphasis of a country on codified law, as opposed to precedent law. For simplicity, in line with La Porta et al. (1998), we use the term 'civil law' throughout this paper.

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