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The effects of mandatory IFRS adoption and conditional conservatism on European bank values

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ABSTRACT

This study examines the relationship between the value relevance of accounting information and the conditional conservatism of the European banking sector. Using a bank data set from 15 European countries we study the value relevance of accounting information before and after mandatory IFRS adoption, as well as the extent to which conditional conservatism and value relevance coexist in this context. Our findings suggest that conditional conservatism is positively (negatively) related to value relevance prior to (post) mandatory IFRS adoption. This finding validates the IASB's objectives of higher value relevance and lower conservatism. Additional analyses provide evidence that country-specific features not only affect the potential increase in accounting quality, but also the relationship between value relevance and conditional conservatism.

1. Introduction

According to the International Accounting Standards Board (IASB), value relevance is a desirable qualitative feature of financial reporting that enhances accounting quality. However, the qualitative substance of conditional conservatism has been partly ignored. Although the IASB Conceptual Framework for Financial Reporting (IASB, 2010) de-emphasizes the importance of conservatism, previous research refers to conditional conservatism as an important qualitative characteristic that improves contracting processes and facilitates decision-making functions (Watts, 2003a).

Using a sample of listed banks from 15 European countries we gauge the level of value relevance before and after IFRS adoption, and examine its relationship to conditional conservatism. We then investigate how this relationship changed after mandatory IFRS adoption. If the IASB achieved its purpose, we expect higher value relevance and lower conservatism, i.e., an inverse relationship.

We analyze European credit institutions for two reasons. First, International Accounting Standard (IAS) 39 is alleged to have considerable influence on financial statements in the banking sector vis-à-vis in any other industry. The introduction of fair value measurement with specific rules for the measurement and recognition of financial instruments resulted in a mixed

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model that uses both fair and historical values. In this context, financial instruments are treated asymmetrically depending on their classification. Thus the measurement of price changes may harm the value relevance of accounting information.

Additionally, financial firms have been partly ignored from value relevance studies because of their sector-specific accounting procedures and their special supervisory treatment. More importantly, the impact of IFRS and/or conservatism on value relevance in the financial sector largely remains under-researched. Prior studies demonstrate that financial firms may behave differently upon IFRS adoption when compared to other sectors (Barth, Landsman, Lang, & Williams, 2012; Gastón, García, Jarne, & Laínez Gadea, 2010; Nobes, 2013). Given the banking sector's pivotal role in financial markets, it is intriguing to explore how this industry reacted to IFRS adoption, and inevitably to the recent global financial crisis.

We use two models to gauge value relevance. When examining the price model we find a significant increase in the informativeness of earnings and a significant decrease in book value relevance following IFRS adoption. Similarly, the return model depicts a significant increase (drop) in earnings (change of earnings) relevance after mandating IFRS. Both models suggest that conditional conservatism is positively (negatively) related to value relevance prior to (post) mandatory IFRS adoption. However, we show that conservative recognition should not be treated negatively by the IASB vis-à-vis other accounting quality properties, such as value relevance.

The remainder of the paper is organized as follows. Section 2 analyses the extant literature. Section 3 provides the methodology, and Section 4 presents the data. Section 5 reports and discusses the empirical results, and Section 6 includes additional analyses. Section 7 provides concluding remarks.

2. Literature review

Value relevance of earnings is "the degree to which accounting earnings summarize information impounded in market prices" (Brown, He, & Teitel, 2006). Higher value relevance suggests greater decision usefulness to investors (Collins, Maydew, & Weiss, 1997; Francis & Schipper, 1999; Lev & Zarowin, 1999), since value relevance metrics presumably capture both relevance and reliability (Barth, Beaver, & Landsman, 2001). On the other hand, according to Basu (1997, p. 4), conservatism is interpreted as "capturing accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements". More timely recognition of 'bad news' in relation to 'good news' is a sign of conservatism, and the corresponding model is based on this principle. This type of conservatism is known as conditional. In contrast, unconditional conservatism refers to a bias towards lower book values of equity and net assets in comparison to their market value. Beaver and Ryan (2005) provide a thorough analysis of the differences between these two forms of conservatism. Despite severe criticism (Dietrich, Muller, & Riedl, 2007; Gigler & Hemmer, 2001; Givoly, Hayn, & Natarajan, 2007; Patatoukas & Thomas, 2011), the Basu model is still a well-recognized and widely-used measure of conditional conservatism (Ball, Kothari, & Nikolaev, 2013).

Extant literature considers both the value relevance of accounting information and conditional conservatism desirable features in financial reporting that enhance accounting quality. With respect to the value relevance of accounting figures, results are mixed. Several studies do not find higher value relevance under IFRS compared to local standards (Aubert & Grudnitski, 2011; Clarkson, Hanna, Richardson, & Thompson, 2011). However, other studies, such as Barth et al. (2012), provide findings in the opposite direction. Aharony, Barniv, and Falk (2010) also detect increased value relevance when assessing three accounting items (i.e., goodwill, research and development expenses and asset revaluation) after IFRS adoption in Europe. Agostino, Drago, and Silipo (2011), the only European bank-related post-IFRS adoption study on value relevance so far, demonstrate an increase (decrease) in earnings (book value) after the compulsory adoption of IFRS.

On a country-specific level, results also are mixed. Gjerde, Knivsflå, and Sættem (2008) find limited evidence of increased value relevance following IFRS adoption in Norway, while Iatridis and Rouvolis (2010) report increased value relevance for both earnings and book value following IFRS adoption in Greece. Using a sample of firms from five European countries for the period 2002–2007, Devalle, Onali, and Magarini (2010) report increased (decreased) value relevance of earnings (book values). However, when each country is analyzed separately, they report mixed evidence concluding that other factors related to national differences play a significant role.

Moreover, prior literature has provided several findings on conditional conservatism and its importance in the banking sector. Research in the US banking sector shows that publicly traded banks are associated with higher conditional conservatism compared to private banks (Nichols, Wahlen, & Wieland, 2009). More effective governance practices also are associated with higher levels of conditional conservatism (Leventis, Dimitropoulos, & Owusu-Ansah, 2013). In the European context, Gebhardt and Novotny-Farkas (2011) compare accounting quality prior to and post mandatory adoption of IFRS (years 2000–2007) based on the intuition that IAS 39 leads to the delayed recognition of loan losses. They find that the asymmetric timeliness of loan-loss provisioning was reduced after 2005. They suggest that this finding is consistent with the fact that IFRS restrict loan-loss provisioning by allowing only incurred losses, thus limiting banks' ability to timely recognize losses.

As for the relationship between conservatism and value relevance, studies from the UK and Korea demonstrate that the association between market values and accounting information is strengthened in the presence of timely loss recognition (Ball & Shivakumar, 2005; Choi, 2007). Other studies show that this may not necessarily be the case. Kousenidis, Ladas, and Negakis (2009) argue that very high or very low conservatism is connected to lower levels of value relevance, while medium conservatism is associated with higher value relevance in Greece. However, the above studies use different geographical,