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The Effect of IFRS Adoption Conditional Upon the Level of Pre-adoption Divergence

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Abstract

Prior studies on whether or not International Financial Reporting Standards (IFRS) adoption improves earnings quality have found mixed results. We note that some of the countries that have adopted IFRS had national accounting standards similar to IFRS prior to adopting IFRS, while others had national accounting standards divergent from IFRS. We examine the effects of IFRS adoption by taking into account the level of divergence prior to the adoption of IFRS. We find that countries experience a greater drop in earnings management when they have a higher level of divergence from IFRS prior to IFRS adoption. More specifically, high divergence countries with higher levels of enforcement benefit the most followed by high divergence countries with lower levels of enforcement. Lower divergence countries with higher levels of enforcement do not significantly benefit from IFRS adoption. Lower divergence countries with lower levels of enforcement do not benefit from IFRS adoption at all. Our results support the contention that countries with lower quality local accounting standards prior to IFRS adoption benefit more from IFRS adoption.

JEL classification: M41
Keywords: IFRS adoption; Pre-adoption divergence; Earnings quality; Enforcement

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1. Introduction

As of 2012, more than 120 countries and reporting regions either permit or require their national accounting standards to be based on International Financial Reporting Standards (IFRS) or a local variant of IFRS. The convergence to IFRS is being driven by two purposes: the call for high-quality accounting standards around the world and the international comparability of financial information. Both are expected to reduce firms' costs of capital and mitigate the adverse selection problems and moral hazards faced by investors (Rahman, Perera, & Ganesh, 2002). In this study, we focus on the first reason for the convergence to IFRS, the call for high-quality accounting standards.

Accounting studies have examined whether IFRS adoption improves earnings quality, but the results remain inconclusive. Some studies find that IFRS-adopting countries have lower levels of earnings management (e.g., Barth, Landsman, & Lang, 2008; Daske, Hail, Leuz, & Verdi, 2008; Hoque, van Zijl, Dunstan, & Karim, 2012), while others find that IFRS adoption has no effect on earnings management or it even increases earnings management (e.g., Ahmed, Neel, & Wang, 2012; Callao & Jarne, 2010; Capkun, Collins, & Jeanjean, 2012; Christensen, Lee, & Walker, 2008; Jeanjean & Stolowy, 2008).

An explanation for the mixed results is that these studies do not take into consideration that some of the IFRS-adopting countries had accounting standards similar to IFRS prior to adopting IFRS, such as the United Kingdom (UK) and Australia. We contend that the term "adoption" does not carry the same meaning for all IFRS-adopting countries and that the benefits of IFRS adoption are greater for countries whose accounting standards are more divergent from IFRS prior to the adoption of IFRS.

Likewise, we examine the effects of pre-adoption divergence between national GAAP and IFRS on earnings management. Similar to some prior studies (e.g., Burgstahler, Hail, & Leuz, 2006; Hoque et al., 2012), we find that countries adopting IFRS experience lower earnings management. However, we find that countries with accounting standards with higher divergence from IFRS benefit more from IFRS adoption. Further tests show that countries with higher divergence and higher levels of enforcement benefit the most, followed by countries with higher divergence and lower levels of enforcement. Countries with lower divergence and higher levels of enforcement do not significantly benefit from IFRS adoption, and countries with lower divergence and lower levels of enforcement do not benefit from IFRS adoption. Our results show that IFRS adoption improves earnings quality for higher divergence countries, with or without higher levels of enforcement.

Our results also show that while legal enforcement is a significant factor in reducing earnings management, its influence on enhancing the effects of IFRS on earnings management reduction is not consistently significant. The reason for this is that most countries with high divergence, with or without high enforcement, benefit from IFRS adoption, and countries with high enforcement but low pre-IFRS divergence do not significantly benefit from IFRS adoption. Consequently, the reduction in earnings management is primarily driven by IFRS adoption.

A point to note here is that IFRS adoption does not mean that the countries simply change their accounting standards. To adopt new, more effective standards, countries have been updating their accounting infrastructure (for example, their auditing standards and corporate governance requirements). These issues are outside the scope of this paper and are being examined in auditing and corporate governance research.