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How has the international harmonization of financial reporting standards affected merger premiums within the European Union?☆

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ABSTRACT

We investigate the impact of IFRS adoption on merger premiums. Using a comprehensive database of M&A deals within the EU during 2000–2011 we examine the role of overall IFRS adoption, the differences between voluntary and mandatory adopters and the role of the target country's pre-IFRS accounting infrastructure and framework (absence of IFRS and IAS). We find that the introduction of the mandate is generally associated with lower merger premiums paid to targets. This decline is more pronounced in deals where the targets are mandatory adopters. We also find that the further away the target's country standards are from IFRS, the stronger the effect of IFRS adoption is on merger premiums. The results are robust to an exhaustive number of control variables and alternative model specifications, as well as across different subsamples.

1. Introduction

There has been a substantial growth in global merger and acquisition (M&A) activity from under $20 billion in 1967 to $2.4 trillion by 2010 with much of the growth occurring in the form of M&A waves. The extant literature on the fifth merger wave, which spanned from 1993 to 2000, is of particular interest given that the majority of M&A deals during this period were characterised by significant overvaluation and overpayment by the acquiring firms (Andrade, Mitchell, & Stafford, 2001). Towards its end however there were significant changes in terms of the general macro and microeconomic environments with key advancements regarding corporate governance and capital market structures. All of these influences in turn are believed to have affected M&A activity as well as the diversity in the valuations between acquirers and targets within the sixth merger wave, which occurred from 2003 to 2007 (Alexandridis, Mavrovitis, & Travlos, 2012).

One of the most significant developments, which occurred after the fifth merger wave within the European Union, was the international harmonization of financial reporting standards whereby, following EU Regulation no.1606/2002, all EU listed firms were required to adopt the International Financial Reporting Standards (IFRS).[1] With the aforementioned regulation becoming effective from the 1st of January 2005, a widespread convergence from country specific Generally Accepted Accounting Principles (GAAP) to IFRS was noticeable, with more than 7000 EU firms adopting the new standards. This has stimulated discussion on the perceived theoretical impact of IFRS on firm valuations and the subsequent effects on M&A premiums. Given the remit of the IFRS (see Section 2.1), it was widely expected that a single set of accounting rules would eliminate international differences in financial accounting standards and enhance comparability (Ball, 2006). This was expected to reduce information asymmetries and uncertainty in take over decisions within M&A transactions, which in turn would be reflected upon M&A premiums (e.g. Zhu & Jog, 2009). While empirical studies have investigated the effect of these changes on a number of reporting indicators (for a review see Brown, 2011) and the consequences of divergence from country-specific standards to IFRS within the EU (Ding, Hope, Jeanjean, & Stolowy, 2007), there has been no examination of the direct link between the adoption of IFRS and M&A premiums. This is unfortunate, given the number of channels through which the newly adopted accounting standards could influence the latter and consequently shape the nature and volume of future M&A activity. More importantly, given the on-going IFRS–GAAP convergence project within the US, there is a strong case to be made on the importance of examining the link

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[1] See Soderstrom and Sun (2007), Pope and McLeay (2011) and Brüggemann et al. (2013) for a comprehensive discussion on the motivation for IFRS adoption.

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between IFRS adoption and merger premiums. As expounded by Pope and McLeay (2011), research on the experiences of IFRS adopters can inform regulators in countries that are in the process of introducing IFRS, and offer invaluable insights for shaping their national policies. To address this gap, we study the impact of IFRS adoption on merger premiums within a sample of 15 EU countries between 2000 and 2011.

Our analysis provides evidence that will be useful in understanding the economic value of transparency and financial reporting uniformity within and across countries. This paper contributes to the literature on three fronts: First, it sheds light on the overall relationship between the adoption of the IFRS and merger premiums across the 15 core EU countries and evaluates whether the adoption has indeed led to better comparability and transparency of investment opportunities and lower costs of capital. Secondly, it differentiates between voluntary and mandatory adopters with regards to the IFRS-merger premium relationship thus contributing to the growing literature that highlights possible intrinsic differences and asymmetric economic consequences between the two (Daske, Hail, Luez, & Verdi, 2008; Li, 2010). Thirdly, the study identifies whether the pre-adoption differences in the regulatory frameworks across the sample countries have implications for merger premiums, hence informing the relevant literature on the role of cross-country variations and the asymmetric impact of IFRS. Therefore, the study adds mutually to the existing literatures on the capital market effects of IFRS and on the impact of the regulatory environment on merger activity and merger premiums in general.

We find that on aggregate, IFRS adoption has lowered merger premiums by approximately 7 to 8% across the sample. In addition, we find that the negative relationship between IFRS adoption and M&A premiums is stronger for mandatory adopters than for voluntary adopters. We also find evidence that the differences between the IFRS standards and the prior regulatory framework of the target country explain in part the drop in merger premiums; in countries where the domestic GAAP is significantly different (lower quality) from IFRS, the adoption of the latter has had a more negative impact on merger premiums.

The remainder of this paper is organised as follows; the next section reviews the relevant IFRS and M&A literatures, which provide the framework and motivate the hypotheses for this study in section three. Section four describes the sample and the data, while section five presents our empirical analysis, along with robustness tests. In the last section, we draw conclusions and discuss pertinent practical and policy implications of the findings.

2. Literature review

2.1. Motivation for International Financial Reporting Standards (IFRS)

Since the issuance of the EU directives in the 1970s and 1980s, and the enactment of Sarbanes Oxley in 2002 in the US, there has been a call for international accounting harmonization and the convergence of global accounting standards. The move towards a single set of accounting rules has been motivated by the principal aim to eliminate international differences in financial accounting standards and enhance comparability (Ball, 2006). This need largely rose to prominence within developed countries, typically characterised by sophisticated capital markets and multinational companies, in order to reduce informational asymmetries between firm 'insiders' who would be better informed than 'outsiders', and improve capital allocation efficiency (Brown, 2011). According to Article 2 of the IFRS Foundation Constitution, the International Accounting Standards Board (IASB) was charged with developing a single set of high quality, globally accepted, financial reporting standards, to convey transparent and comparable information and promote the convergence of national accounting standards towards IFRS (Pope & McLeay, 2011). These requirements were subsequently mandated on 6th June 2002 by the EU Council through a statement that required all listed companies to adopt IFRS from 1st January 2005 onwards.

2.2. Extant evidence on IFRS effects

There is indeed a rich body of research that investigates the consequences from the adoption of the IFRS mandate (Kim, Liu, & Zheng, 2012). Most studies within this literature examine the economic effects of IFRS, namely the impact of financial reporting on the decisions of the firm and its various stakeholder groups (Zeff, 1978). These economic effects fall under three main categories: financial reporting, capital market and macroeconomic effects (Brüggemann, Hitz, & Sellhorn, 2013). Since a comprehensive review would fall beyond the scope of the study, we focus mainly on international studies and on the key areas of interest for our research, namely the IFRS effects on the quality of reporting and on capital market outcomes.

In the first group of studies, Daske and Gebhardt (2006), using disclosure quality scores from accounting experts, conclude that the quality of reporting increased for both voluntary and mandatory IFRS adopters in Austria, Germany and Switzerland. Barth, Landsman, and Lang (2008) in their study across 21 countries also report that for voluntary IFRS adopters the accounting quality improved, as evidenced by less earnings management and more timely loss recognition, among others. Along the same lines, in their study of the EU15, Chen, Ting, Jiang, and Lin (2010) provide evidence of reduced earnings management, lower discretionary accruals and higher earnings quality for mandatory adopters. A number of studies in individual national jurisdictions within the EU confirm the above findings (see for example Iatridis, 2010 for the UK) and conclude that IFRS has indeed improved the quality of disclosures within their respective samples. On the other hand, Ahmed, Neel, and Wang (in press) in their investigation of firms from 20 countries and using entities from non-adopting jurisdictions as a control sample, report contrasting findings: IFRS adopters exhibit increased income smoothing, more aggressive accruals reporting and a decrease in the timeliness of loss recognition. Similarly contrasting results are reported from other multi-country (i.e. Jeanjean & Stolowy, 2008 in Australia, France and UK) and single-country (Hung & Subramanyam, 2007; Van Tendeloo & Vanstraelen, 2005 in Germany) studies. A common denominator in most of the above studies is that IFRS effects differ among countries, supporting that the regulatory and institutional frameworks may moderate or accentuate the effects.

In the second group of studies, Daske et al. (2008) in their investigation of the IFRS effects on market liquidity, cost of capital, and Tobin's q in 26 countries report increases in the liquidity and equity valuations and declines in the cost of capital of IFRS adopters. Similarly, Li (2010) reports that mandatory IFRS adoption in 18 EU countries reduces the cost of equity capital, but only for those firms operating under strong legal enforcement jurisdictions and more significantly for mandatory adopters. Along the same lines Aharony, Barniv, and Falk (2010) and Yip and Young (2012), find mandatory IFRS adoption to increase the value relevance of financial reports, with the effect being different in magnitude among the countries in their respective samples. Finally, Barth, Landsman, Young, and Zhuang (2012) give evidence that IFRS restated earnings figures are more value-relevant than domestic GAAP ones for 1201 firms in 15 European countries. Similar evidence is provided for comparable economic effects (i.e. risk relevance) by single country studies (see for example Papadamou & Tzivinikos, 2013, for Greek banks).

Overall, while there is a reasonable consensus within the body of research on the capital market effects of IFRS adoption (in terms of increased value relevance, lower cost of equity, etc), the same cannot be said for the IFRS effects on the quality of accounting information. As there is no conclusive evidence on the capacity of the IFRS to achieve higher quality financial reporting, there is a lot of merit in extending the debate further with new research directions (Brüggemann et al., 2013).

2.3. IFRS consequences on M&A premiums

Within the M&A context, a harmonized reporting framework is expected to reduce the costs of information asymmetry for acquiring