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The impact of mandatory IFRS adoption on foreign mutual fund ownership: The role of comparability ☆

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ABSTRACT

Proponents of IFRS argue that mandating a uniform set of accounting standards improves financial statement comparability that in turn attracts greater cross-border investment. We test this assertion by examining changes in foreign mutual fund investment in firms following mandatory IFRS adoption in the European Union in 2005. We measure improved comparability as a credible increase in uniformity, defined as a large increase in the number of industry peers using the same accounting standards in countries with credible implementation. Consistent with this assertion, we find that foreign mutual fund ownership increases when mandatory IFRS adoption leads to improved comparability.

1. Introduction

Comparability is a qualitative characteristic of financial information that enhances its usefulness (Financial Accounting Standards Board (FASB), 1980, 2008; International Accounting Standards Board (IASB), 1989, 2008). Advocates of mandatory IFRS adoption claim that IFRS increases financial statement comparability, which in turn leads to greater cross-border investment (e.g., Securities and Exchange Commission (SEC), 2008; Tweedie, 2008). The notion is that improved financial statement comparability reduces the information acquisition costs of global investors and thereby increases their investment in foreign firms (Kang and Stulz, 1997; Morgan Stanley Dean Witter, 1998). The purpose of this

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study is to test this assertion by examining whether the EU's mandatory adoption of IFRS in 2005 results in improved comparability that leads to increased investment by foreign mutual funds.

Comparability is defined as the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena (FASB, 2008; IASB, 2008). Proponents of mandatory IFRS adoption argue that increased uniformity improves financial statement comparability (McCreevy, 2005; Bielstein et al., 2007). This is consistent with the FASB/IASB Conceptual Framework, which argues that comparability is the desired outcome of adopting a uniform set of accounting standards (such as IFRS). However, requiring firms to use a set of uniform accounting standards does not necessarily result in improved comparability (FASB, 2008; IASB, 2008). We expect two factors to impact the extent to which the increased uniformity from mandatory IFRS adoption improves comparability. One factor is what we term implementation credibility, which we define as management's faithful application of IFRS. The Conceptual Framework argues that a uniform set of standards only increases comparability when it is faithfully applied (i.e., credibly implemented). Financial reporting quality varies across countries and managers have flexibility in implementing IFRS (Nally and Kaplan, 2007; Henry, 2008). Thus, IFRS adoption is only likely to improve comparability when it is credibly implemented. We proxy for implementation credibility in our tests using the earnings quality score from Leuz et al. (2003). Another factor impacting comparability is the magnitude of the increase in uniformity. We measure the increase in uniformity as the change in the number of industry peers using the same accounting standards subsequent to IFRS adoption. The magnitude of the increase in uniformity varies across firms because the increase in comparable industry peers from IFRS adoption varies across countries and industries. We only expect IFRS adoption to improve comparability when it results in a reasonably large increase in uniformity. Thus, IFRS is only likely to improve comparability when there is strong implementation credibility and a large increase in uniformity (i.e., when there is a credible increase in uniformity).

As in Armstrong et al. (2010) and Li (2010), we focus our analysis on mandatory IFRS adoption in the EU. This is a unique setting for investigating the impact of financial reporting uniformity and comparability because thousands of public companies in the EU ceased using their countries' local accounting standards in 2005 and simultaneously adopted a uniform set of reporting standards. We use foreign mutual fund ownership to capture cross-border investment because mutual funds represent a sophisticated set of investors that are likely to base their investment decisions on detailed analysis of financial statements and are therefore likely to benefit from improved comparability. Thus, we hypothesize that firms experience larger increases in foreign mutual fund ownership when there is a credible increase in uniformity from mandatory IFRS adoption in the EU.

We test our hypothesis using 5,460 firm-year observations of mandatory adopters (who use IFRS only after it is mandated in 2005) in 14 EU countries during the period of our analysis, 2003–2007. Consistent with our hypothesis, we find that mandatory IFRS adoption results in a greater increase in foreign investment among companies in countries with strong implementation credibility that experience relatively large increases in uniformity. We also find that these companies are the only firms with a significant increase in foreign mutual fund ownership.

We also perform two analyses intended to corroborate the findings in our hypothesis test. Our first additional analysis, as expected, finds that a credible increase in uniformity associated with mandatory IFRS adoption in the EU does not increase domestic mutual fund ownership. This is consistent with domestic investors having better access to alternative information channels (such as managers and local analysts) and being more familiar with local accounting standards (Covrig et al., 2007). Our second additional analysis, also as expected, finds that the effect of comparability on foreign mutual fund ownership is primarily driven by foreign global funds, as opposed to foreign regional, country, and other funds. This finding is consistent with foreign global funds having investments across a large number of countries, and hence being more likely to benefit from benchmarking with a large set of firms. Finally, we find that our results are robust to a variety of sensitivity tests.

Our findings make several contributions to the literature. First, we provide evidence that both implementation credibility and increased uniformity are important factors leading to improved comparability. Consistent with the FASB/IASB Conceptual Framework, our findings suggest that uniformity does not necessarily lead to comparability, and that the effects of adopting a uniform set of accounting standards on cross-border investment critically depend upon the economic institutions and management incentives in the adopting country. This finding is also consistent with the message in Holthausen (2009), which argues that enforcement is likely to play an important role in whether a uniform set of accounting standards, such as IFRS, actually leads to improved comparability.

Second, we add to a growing body of working papers that examine the effects of mandatory IFRS adoption on cross-border investment (e.g., Beneish et al., 2009; Bruggemann et al., 2009; Florou and Pope, 2009; Yu, 2010).[1] This stream of research is particularly important because it investigates a potential "real effect" of accounting, which is somewhat rare in the literature. Beneish et al. (2009) examine the effect of mandatory IFRS adoption on cross-border investment in equity and debt markets. Florou and Pope (2009) examine the effects of mandatory IFRS adoption on foreign institutional investors, and Bruggemann et al. (2009) examine the effects on foreign individual investors.

[1] Another line of literature on IFRS adoption examines the benefits from *voluntary* IFRS adoption (e.g., Covrig et al., 2007). We focus our discussion on studies examining mandatory IFRS adoption because voluntary IFRS adoption, when it is not yet widely used, can actually reduce firms' comparability with their peers. This suggests that studies examining voluntary IFRS adoption generally document the effects of increased disclosure, not improved comparability.