



Comparative evidence on the value relevance of IFRS-based accounting information in Germany and the UK



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ABSTRACT

This paper uses panel cointegration with a corresponding vector error correction model (VECM) to investigate the changes in the value relevance of accounting information before and after the mandatory adoption of IFRS in Germany and the UK under three different valuation models. First, a basic Ohlson model, where our results indicate that despite the value relevance of the book values of equity has declined, it has been replaced by the increasing prominence of earnings in both Germany and the UK after the switch to the IFRS. Second, a modified model, which shows that the incremental value relevance of both earnings and book values are considerably higher in the long term for firms in the UK than in Germany. Third, a simultaneous addition of accounting and macroeconomic variables in an extended model, which indicates a significant rise in the relative predictive power of the book value of equity in the UK compared with the more noticeable impact on the value relevance of earnings in Germany. Collectively, the results of these models indicate that: (i) the explanatory power of linear equity valuation models is higher in UK than in the Germany, (ii) a long-run Granger-causal relationship exists between accounting variables and share prices in common law countries like the UK. Nevertheless, the implications of our findings lie in the knowledge that the potential costs of switching to the IFRS is completely nullified within three years by the benefits arising from a reduction in information asymmetry and earning mismanagement among firms which are listed on the stock exchanges of both common law and code law-based EU countries.

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1. Introduction

In February 2001, the European Union (EU) proposed a regulation that would require all firms listed on EU stock exchanges to prepare consolidated financial statements in accordance with International Accounting Standards (IAS), currently referred to as International Financial Reporting Standards (IFRS). This obligation was effective from 1 January 2005 onwards and

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entailed 7000 European listed companies complying with IFRS in all published consolidated accounting statements commencing on or after this date. According to regulatory bodies the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), an accounting system provides users with useful information which will be incorporated into their decision-making. Motivated by testing such regulatory claims, many researchers have addressed the relative impact of IFRS in common law countries as opposed to code law countries. They normally define an accounting amount as value-relevant, if it has a predicted association with equity market values (Barth, Beaver, & Landsman, 2001; Barth, Landsman, & Lang, 2008; Clarkson, Hanna, Richardson, & Thompson, 2011; Jermakowicz & Gornik-Tomaszewski, 2006; Yip & Young, 2012).

Distinctively from the above-mentioned literature, this paper explores and compares the value relevance of accounting information in Germany and the UK under three different versions of a linear equity-valuation model. First, it employs the basic *Ohlson model*, used as a benchmark or a baseline model which regresses stock price or market value per share (*MVPS*) on two key financial variables, book value per share (*BVPS*) and earnings per share (*EPS*), as the primary explanatory variables of interest. Second, it modifies this simple expression by including a set of conditioning accounting variables, including leverage (*LEV*) and dividend payout (*DIVP*), to investigate the influence of other financial accounting information on share prices. The objective is to highlight the sources of the changes in the explanatory power of our basic Ohlson model. Third, it develops an extended equity valuation model by adding simultaneously a group of accounting and macroeconomic factors to the basic Ohlson regression. The outcome will shed light on the extent of complementarity of financial accounting and non-financial economic data.

Results from our VECM uncovered five key findings. They are: (i) under the *basic Ohlson model*, while the value relevance of book value of equity has declined, it has been replaced by the increasing prominence of earnings in both Germany and the UK, (ii) under the *modified model*, the incremental value relevance of earnings and book values is increasing in the long term for UK rather than for German firms, (iii) under the *extended model*, the predictive power of the book value in the UK has risen, the impact of the economic indicators is, however, more noticeable in the increase in the value relevance of reported earnings in Germany. Overall, comparing the value relevance of accounting information within each country prior and post the mandatory adoption of IFRS suggests that the coefficients on the book value and earnings variables are persistently positive across the two periods among our sample of UK firms. Furthermore, an increase in the size of the parameter coefficients within each country before and after the transition to IFRS implies that the figures provided in accordance with the IFRS are more informative than the numbers produced under the original local GAAP. These results have important implications for regulatory bodies as they confirm the ability of IFRS in improving the quality of accounting numbers regardless of the basis of their original accounting reporting system. Such helps inform the ongoing debate on whether the international differences will persist in the post-IFRS era (e.g., Elshandidy & Shrivies, 2016; Nobes, 2006). These results also have consequences for investors as they lend credibility to the predictive power of accounting numbers prepared under IFRS. Further, equity investors should be able to compare the quality of reported accounting numbers across the EU countries with the intention of re-assessing their investment strategies in the aftermath of the mandatory switch to the IFRS framework. From an academic research viewpoint, our results emphasise the importance of (i) combining different factors that capture firm-and country-characteristics while observing the impact of accounting reporting standards on stock prices and (ii) employing advanced econometric techniques (i.e., VECM) that account simultaneously for misspecification bias that cannot be easily captured by conventional models (i.e., OLS).

This paper therefore contributes to the literature on value relevance in *three* distinct ways. First, it answers the question: Does the adoption of IFRS improve the value relevance of accounting information and if so, how might it differ between firms in code law and common law countries as represented by Germany and the UK respectively?

Second, it examines the value relevance of a simultaneous addition of reported accounting and macroeconomic factors using a sample of firms listed on two different European Stock Exchanges – Germany and the UK – in the three years immediately before and after the transition to IFRS. The end date was prior to the 2008/09 financial crisis and so avoids any possible distortion that this upheaval may have had on selected firm performance indicators. These two jurisdictions comprise a strongly contrasting pair that epitomise extremes of established bank and market-based economies respectively in the European Union (EU). In the UK and other common law countries, firms deal with other external parties such as institutional and minority investors at “arms-length” leading to demand for accurate and timely information on firm financial performance measures (Ball, Kothari, & Robin, 2000). By contrast, in Germany and other code law countries, insider owners such as banks participate in firm decision-making through supervisory board membership. As such this provides them with direct access to firm performance information. Our research complements the studies by Ball et al. (2000) and Daske and Gebhardt (2006) who explored the other benefits of IFRS adoption. They noted that a reduction in measurement error following the introduction of IFRS should encourage investors to rely less on “other information” sources.

Third, it assesses the degree of cointegration and causal relationships between accounting and macroeconomic variables of interest, in the long-run, using the traditional Johansen-Fisher panel co-integration model with a related vector error correction model (VECM). The analysis is based on a dynamic annual panel data framework which integrates the short and long-run relationships between stock prices and our chosen financial and non-financial economic indicators. Such an approach corrects for the number of misspecification errors, including the presence of unit roots in data and joint simultaneity of explanatory variables which may bias estimates from conventional OLS regressions. A VECM approach conforms to the findings of Kothari and Zimmerman (1995) and Amir and Lev (1996) that an empirical model which incorporates both asset returns and price level data has the potential to yield “more convincing” value-relevant information. From an accounting

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