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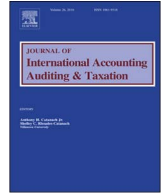

Capital market effects of mandatory IFRS 8 adoption: An empirical analysis of German firms

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ABSTRACT

In this paper, we analyze capital market effects associated with the mandatory adoption of IFRS 8 for a sample of German firms. Our research is motivated by the change in segment reporting rules due to the adoption of the management approach resulting from the IASB and FASB short-term convergence project. In particular, we use a difference-in-differences design to investigate whether firms applying IFRS 8 experience a decrease in information asymmetry and/or an increase in forecast accuracy. We document no significant decline in information asymmetry, measured by bid-ask spreads and depths, and no significant increase in forecast accuracy, measured by forecast errors, between the pre and post IFRS 8 periods for mandatory adopters relative to a group of control firms. Thus, we find no unique effects of the mandatory adoption of IFRS 8 for German firms. Our results indicate that adopting supposed US 'best practice' might not necessarily be the best choice for every IFRS-applying country. Our findings should be of interest to the IASB, which finished its post-implementation review of IFRS 8 in 2013 and is currently considering potential changes to IFRS 8.

1. Introduction

Even though segment disclosures are commonly recognized as an indispensable source of information for evaluating a firm's financial position and prospects (AIMR, 1993), the adequacy of the underlying segment reporting principles has been the subject of ongoing debates in standard-setting over the last two decades (AICPA, 1994; Pacter, 1993). In November 2006, the IASB issued IFRS 8 as part of its short-term convergence project with the US standard-setter FASB. It thereby adopted the management approach to segment reporting, following the example of the US standard SFAS 131. IFRS 8 was effective for fiscal periods beginning on or after January 1, 2009, with earlier application permitted. Under the management approach, firms are required to disclose segment data based on their internal organization and on the nature and extent of information that is used by management for making decisions about resources to be allocated to operating segments and assessing segment performance. In comparison, previous US and international standards (SFAS 14, IAS 14, IAS 14R) used the risks and rewards approach as an overriding principle. This approach required firms to report segment information by both lines-of-business and geographic areas, whereby activities with similar risks and returns had to be placed in the same segment. Further, under the risks and rewards approach segment information was prepared using accounting policies in line with the IFRSs (McConnell and Pacter, 1995).

The standard-setters' adoption of the management approach was supported by financial statement preparers. They argued that

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segment disclosures under the management approach would provide more relevant information and emphasized the benefits that users would gain from seeing the company "through management's eyes" (Martin, 1997, p. 29). By contrast, opponents of the management approach, which consisted mainly of investors and other users, were concerned about lack of comparability and increased discretion compared to the prescriptive rules of the predecessor standard IAS 14R (e.g., Kwok & Sharp, 2005). Similarly, the European Parliament expressed serious concerns about IFRS 8's adoption and called on the European Commission to carry out an in-depth impact assessment before making a decision on the endorsement of IFRS 8.

The IASB did not expect to encounter so much criticism as it had simply adopted US rules that seemed to have been working satisfactorily for almost ten years. Accordingly, in its Basis for Conclusion to IFRS 8, the IASB referred to empirical evidence indicating that the management approach of SFAS 131 improved segment reporting practices and increased the usefulness of segment information in the US (IFRS 8, BC.6). However, it is problematic to generalize results from one jurisdiction as institutional arrangements may differ in important ways (Fülbier, Hitz, & Sellhorn, 2009). This is particularly the case with the US setting compared to the context of IFRS-applying countries. Therefore, it is not at all evident, but rather an empirical question to assess whether the mandatory adoption of IFRS 8 has had a positive impact on the usefulness of segment disclosures in any IFRS-applying country. Instead, there are several indications that contradict such an assumption.

For example, the initial situation for the adoption of the management approach in IFRS-applying jurisdictions was fundamentally different than in the US when SFAS 131 was issued in 1997. In the US, the move from the industry approach of SFAS 14 to the management approach of SFAS 131 meant the introduction of a distinctly new approach to segment reporting. By contrast, the IASB had already decided to include elements of the management approach when revising IAS 14 in 1997. Thus the shift to the 'pure' management approach of IFRS 8 in 2006 represented a minor change for preparers and users of segment information. Empirical evidence shows that benefits of the management approach with respect to segment reporting practices had already partially materialized following the issuance of IAS 14R. Therefore, the potential incremental contribution of IFRS 8's adoption appears uncertain (Nichols, Street, & Tarca, 2013). Recent studies on the impact of IFRS 8 document that segment disclosure practices under IFRS 8 are fairly similar to those under IAS 14R (see Nichols et al., 2013, for an overview).

There could even be negative effects of IFRS 8's adoption due to the abandonment of consistent and IFRS-based disclosures. This might be particularly problematic in German-speaking countries that have traditionally used a 'separate' accounting system design in contrast to countries with an Anglo-American tradition where internal accounting information and procedures are generally dominated by financial reporting requirements (Joseph et al., 1996). A small degree of integration between managerial and financial accounting probably limits the understandability of internal management information for users which in turn could lead to reduced usefulness of the segment information disclosed. Moreover, Continental European countries are characterized by a different reporting culture. Lack of experience in providing segment information and institutional characteristics associated with the code law tradition might result in weak incentives for firms to disclose comprehensive segment information.

Our paper attempts to address whether the mandatory adoption of IFRS 8 increased the usefulness of segment disclosures in Germany as assumed by the standard setter IASB. Specifically, we investigate capital market effects associated with the change to IFRS 8 for a broad sample of German firms listed within the Prime Standard of the Frankfurt Stock Exchange. More precisely, we use bid-ask spreads and depths to proxy for information asymmetries and to make inferences about overall market liquidity effects (e.g., Lee, Mucklow, & Ready, 1993). In addition, we use forecast error as an inverse proxy for forecast accuracy to draw conclusions on the analysts' information environment (e.g., Hope, 2003). Improved usefulness of segment information following IFRS 8's adoption should be reflected in a decline in bid-ask spreads, an increase in depths and a decrease in forecast errors (e.g., Byard, Li, & Yu, 2011; Heflin, Shaw, & Wild, 2005; Leuz & Verrecchia, 2000). In line with prior research (e.g., Muller, Riedl, & Sellhorn, 2011), we utilize a difference-in-differences design, because a simple comparison of pre and post values of the dependent variables for firms exposed to the mandatory accounting change are likely to be contaminated by temporal shifts in the outcome variables or by the impact of other concurrent events (e.g., Abadie, 2005). Thus, we measure changes in our public and analyst information metrics around the mandatory transition to IFRS 8 for mandatory adopters (treatment group) relative to a control group of firms that applied the standard earlier on a voluntary basis and thus are likely unaffected by the mandatory adoption date of IFRS 8.

Contrary to the IASB's expectations (IASB, 2012), our results do not indicate unique capital market effects of mandatory IFRS 8's adoption for German firms. We find that neither pre versus post changes in bid-ask spreads nor in depths or forecast errors for mandatory adopting firms are significantly different from changes found for our control group. In particular, even though mandatory adopters exhibit a significant decline in bid-ask spreads across the pre and post periods which indicates increased liquidity, the decline is not significant relative to the control group. Thus, temporal shifts in the bid-ask spreads experienced by mandatory adopters of IFRS 8 are more likely to be attributable to events affecting all listed firms. Moreover, we document a decline in depths over the sample period suggesting decreased liquidity, in contrast to the result for the bid-ask spreads. Hence, our findings do not allow for unambiguous inferences about the overall change in market liquidity. In relative terms, the mandatory adopting firms exhibit a smaller decrease in depths than the control firms. However, the difference in the differences is also not significant. Furthermore, our findings document that forecast errors significantly increased over the sample period indicating increased uncertainty. However, the result becomes insignificant after controlling for other determinants of forecast errors. In addition, the change in forecast errors across the pre and post periods for mandatory adopters is not significantly different from the change experienced by the control firms. In order to validate our results, we construct a matched sample of the mandatory adopting firms and the control firms by using a propensity score matching. However, even after controlling for potential self-selection, our results remain the same.

Our study offers empirical evidence on the lack of capital market effects associated with the mandatory adoption of IFRS 8 in Germany and thus provides additional information to an increasing body of literature in the wake of IFRS 8 (Franzen & Weißenberger, 2015; Leung & Verriest, 2015). Our results are particularly relevant given that the IASB has recently carried out a

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