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Did the market overreact to the mandatory switch to IFRS in Europe?

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ABSTRACT

I. INTRODUCTION

Thirdly, in a related vein, other studies such as Ahmed et al. (2013) and Barth et al. (2008) examine whether companies following IFRS report losses more frequently than non IFRS companies. However, this measure captures only a very minor part of the expected improvement from IFRS, which should provide improved information about performance well ahead of the company being in a loss making situation.

A fourth approach to accounting quality is the well trodden path of estimating earnings management through discretionary accruals, based on the cross-sectional version of Jones (1991) model. Examples of such studies are Ipino and Parbonetti (2011) and Jeanjean and Stolowy (2008). This measure of quality has promise since it is a well established and broad measure of quality. It is also able to identify different types of earnings management from income smoothing to manipulation towards a target. It achieves this by defining discretionary accruals as those which cannot be explained by the current activity of the firm, which is measured by the change in sales and the level of plant property and equipment.

Given the variety of research methods used to investigate earnings management under

III. CONTRIBUTION

However, accounting for these other factors is problematic. There are weaknesses in capturing differences between IFRS and domestic GAAP; see for example Nobes (2009). The measures used are an aggregate of differences over a large number of areas, and apart from the equal weighting given to each area, the differences are often unsigned, i.e. do not capture whether domestic GAAP is worse or better than IFRS.

The enforcement, or rule of law indices are typically based on perceptions. These, of course, suffer from the potential problem of inter country differences in perceptions, since perceptions are likely to be framed by local conditions. This has led some researchers to regard such indices as fatally flawed (Kurtz and Schrank 2007). In addition, the rule of law indices are not specific enough to accounting (Preiato et al. 2012).

Our country-by-country study removes the need to make such country adjustments. Nevertheless, there still remains the issue of whether changes in enforcement, coinciding with mandatory IFRS, have contributed to the results.¹ Of course, conclusions are always subject to the problem of omitted variables; but if we find that many countries have responded to IFRS in a similar manner, it is less likely that they are *all* the results of changes in enforcement.

A further disadvantage of the investigating countries aggregated together is that it is not clear whether the results obtained are to be found throughout the sample or whether they are driven by just a few countries. This distinction is clearly important from a policy viewpoint.

The Magnitude of the Security Market Impact

The final

understanding the performance of the company from an economic perspective. Goeltz (1991) and Bouwman et al. (1987) make clear that the foremost concern when making investment decisions is not the quality of accounting standards. It is unnecessary to have accounting measurements on exactly the same basis since broad brush adjustments are enough. Therefore, professional investors are likely to take on trust the benefits which are said to come from a common, and improved, set of global accounting standards.

Thirdly, research in behavioural finance suggests that it is difficult for individuals to deviate from the group consensus (Janis 1982; Shiller 2001). This is especially true when judgments are complex and feedback is limited, as in the case of the benefits of accounting standards. In addition, Lo (2004) in the discussion of the Adaptive Markets Hypothesis, argues that investors find it difficult to adapt to a changing environment since the heuristics which have worked in the past are no longer suitable. Obeisance to conventional wisdom is strong.

For these three reasons, (i) the persuasion undertaken by IASB, (ii) the core competence of market agents being outside of accounting, and (iii) the behavioural difficulty of escaping the group consensus, we address the issue of overreaction to the achieved imp

measuring earnings management using the residuals from the cross-sectional Jones (1991) model, is that some residuals may be informative about future cash flows rather than the product of manipulation. McNichols (2002) deals with this by using the relation between accruals and cash flows developed by Dechow and Dichev (2002) to purge the Jones (1991) model residuals of these informative deviations. We estimate the residual from the extended Jones (1991) model by McNichols (2002) as follows :

take earnings at the face value and make adjustments based on their assessment of

Panel B of Table 2 shows the impact of the mandatory adoption of IFRS on accounting quality defined by Equation (1) and (2), as measured by the coefficient β . A positive β implies that accrual quality has improved after the mandatory adoption of IFRS in 2005. The results for the whole sample indicate a positively significant coefficient of 0.0031 with t-statistics of 4.00, suggesting that overall the average accrual quality has improved following the mandatory adoption of IFRS. Our results are consistent with the results of Chen, et al. (2010) and Zeghal, et al. (2012), which find that accounting quality has improved at the aggregate level of 15 EU countries.

[Insert Table 2 about here]

However, in contrast, our results at the individual country level indicate that accruals quality has improved only for a few countries. Our results therefore question the conclusions of other studies that earnings quality consistently

overreaction to the impact of mandatory IFRS adoption in accounting quality. As mentioned above, this situation may arise since (i) there is significant promotion of IFRS by domestic regulators and the IASB, (ii) accounting expertise is not the core concern for security investment decisions and (iii) short-termism makes it difficult to deviate markedly from the market consensus.

Lastly, 7 out of 9 coefficients for excess returns on capital investment are statistically positive across countries. We believe that this variable is able to reflect the impact of expended capital investment on the market value. Our evidence suggests that market value of a company increases with the marginal increase of the profit obtained from further capital investment.

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Table 4 presents the estimation results of Equation 5. Firstly, our results indicate that coefficients of both quality adjusted cash flows from operation and quality adjusted accruals are all statistically positive and significant of all the individual countries. Interestingly, we can find that the extends of the weight of the cash flows from operations and the weight of accruals that investors use during valuation process are similar. Evidence indicates that investors are less able to distinguish between the consistency of accruals and cash flows.

[Insert Table 4 about here]

Our results

VII. CONCLUSION

Our investigation of accounting quality based on McNichols' model (McNichols 2002) suggests that accounting quality with pooled sample of the eight EU countries has improved after the mandatory adoption of IFRS in 2005. However, examination of each individual country shows that accounting quality has been improved only in France, Germany and the Netherland. The evidence questions the existing conclusion that accounting quality has been improved generally, and addresses the issue of prior studies' application of pooled sample data.

The estimation results of earnings and investment opportunity valuation model with accounting quality adjusted earnings suggest that market recognises the possible impact of mandatory adoption of IFRS on accounting quality, but investors actually overreact to the improvement. Given the fa

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APPENDIX

Variable Definition

$ACC_{j,t}$	Change of working capital of firm j in year t at the end of fiscal year scaled by total assets at the end of fiscal year t
$CAPEX_{j,t}$	The ratio of capital expenditure of firm j in year t scaled by total assets at the end of fiscal year t
$CFO_{j,t}$	Cash flows from operations of firm j in year t scaled by total assets at the end of fiscal year t
$Earnings_{j,t}$	Net operating income of firm j in year t scaled by total assets at the end of fiscal year t
$EX_{j,t}$	Excess return on investment at the end of fiscal year t scaled by total assets at the end of fiscal year t , defined as: $CAPEX_{j,t} * [(MTBV_{j,t} - IR_{j,t}) / IR_{j,t}]$
IR_t	3-month T-bill rate at the end of fiscal year t
$MD_{j,t}$	Mandatory adoption dummy, which takes the value of 1 if a firm adopts IFRS from 2005, and 0 otherwise
$MTBV_{j,t}$	Market to book ratio of firm j in year t
$MV_{j,t}$	
$PPE_{j,t}$	
$\hat{e}Rev_{j,t}^{-0.972}$	
$TA_{j,t}$	
WACC	

TABLES

Table 1 Descriptive Statistics and Correlation Matrix

Panel A Descriptive Statistics

MV	Earnings	CFO	ACC
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Table 4 Market Value