IFRS Adoption and Stock Prices of Japanese Firms in Governance System Transition☆

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A R T I C L E   I N F O

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A B S T R A C T

This study examines firms' decision to voluntarily adopt IFRS in a setting where there are changes to the governance system in a traditionally code law country, as well as how the market responds to such decisions. We find the probability of voluntary IFRS adoption to be higher among firms that have a high proportion of foreign shareholders, undertake quality audits, have low levels of leverage, feature a nominating committee, and are included in the new market index. In addition, the stock prices of IFRS adopters tend to increase around the announcement date of IFRS adoption, compared to those of non-adopters. Finally, market reactions are smaller for firms that feature a nominating committee, and are included in the new market index—perhaps because IFRS adoption by these firms is less surprising to market participants, and because IFRS adoption is not expected to add large incremental value to these firms.

1. Introduction

This study examines firms' decision to voluntarily adopt International Financial Reporting Standards (IFRS) in a setting where there are changes to the governance system in a traditionally code law country, as well as how the market responds to such decisions. Japan is the largest economy to adopt IFRS following the EU.1 Since the use of IFRS was allowed, starting in the fiscal year ending in March 2010, 141 firms decided or planned to adopt IFRS by the end of June 2016, according to the Tokyo Stock Exchange (TSE). Although the IFRS have become the most widely used financial reporting standards in the world, whether IFRS adoption is beneficial for the Japanese economy remains an empirical question.

Several prior studies have shown that whether IFRS adoption brings economic benefits depends on institutions and capital market forces, which are related to firms' incentives to disclose more information (Ball, Kothari, & Robin, 2000; Ball & Shivakumar, 2005; Burgstahler, Hail, & Leuz, 2006; Daske, Hail, Leuz, & Verdi, 2008; Li, 2010). Traditionally, Japan has been classified as a code-law (or civil-law) country (Ball et al., 2000; La Porta, Lopez-de-Silanes, & Shleifer, 1998). Code-law countries generally have weaker legal investor protection and enforcement than common-law countries, and so Japan's code-law status generates concerns about whether the benefits of IFRS adoption exceed its costs.

In addition, as is typical in code-law countries, the Japanese governance system has been classified as a “stakeholder governance
system. The stakeholder governance system contrasts with the shareholder governance system of common-law countries, in which shareholders alone elect the governing board. Unlike the shareholder governance system, the stakeholder governance system is characterized by debt financing; shareholders associated with domestic affiliated interests; and interconnected networks among firms, their trading partners, and the main banks (Hoshi & Kashyap, 2001; Shleifer & Vishny, 1997). In particular, the main banks collect private information on debtors, solve agency problems, and provide monitoring and insurance services. Such a system does not apply much pressure on firms to disclose precise information to outside investors.

However, after the collapse of the economic bubble in the 1990s, Japan has made extensive efforts to transform its economic and business environment—which can be observed in a decrease in the traditional cross-shareholding between banks and firms, an increase in foreign shareholders, and more transparent selection of external board members and CEOs (Miyajima, 2014; Wong & Reynolds, 2015). In addition, a new market index, the JPX-Nikkei Index 400, was introduced in January 2014. Firms are selected for the index by the score based on quantitative indicators and qualitative factors. The qualitative factors include the appointment of at least two independent outside directors and IFRS adoption.

Prior studies report that firms with dispersed ownership, high foreign ownership, a functioning and independent board of directors, and an effective audit committee are more likely to adopt IFRS (Covrig, DeFond, & Hung, 2007; Gassen & Sellhorn, 2006; Verriest, Gaeremynck, & Thornton, 2013). Thus, the change in the corporate governance system of the Japanese firms gives rise to the following questions: Do shifts in the governance system of firms in a code-law country affect their decisions to voluntarily adopt IFRS? How do investors evaluate IFRS adoption of firms that have shifted the governance system?

To answer these questions, we first examine the corporate governance characteristics of Japanese firms that announced voluntary IFRS adoption. We then analyze market reactions to announcements of IFRS adoption and investigate how reactions are affected by firms' corporate governance characteristics. We note that according to prior studies, the reason behind stock market changes around voluntary IFRS adoption may be self-selection bias, a form of endogeneity problem, because voluntary adopters may have improved corporate governance and financial conditions prior to IFRS adoption (Christensen, 2012; Kim & Shi, 2012). To reduce such potential self-selection bias, we employ a propensity score matching (PSM) approach and conduct a robustness check by estimating market reactions to public events that promote or deter IFRS adoption because such events are considered to be less susceptible to self-selection problems.

We find that the probability of voluntary IFRS adoption is higher for firms that have a high proportion of foreign shareholders, undertake quality audits, have low levels of leverage, feature a nominating committee, and are included in the new market index. In addition, the stock prices of IFRS adopters tend to increase around the announcement date of IFRS adoption, compared to those of non-adopters. Finally, market reactions are smaller for non-adopters. Thus, the change in the corporate governance system of the Japanese firms gives rise to the following questions: Do shifts in the governance system of firms in a code-law country affect their decisions to voluntarily adopt IFRS? How do investors evaluate IFRS adoption of firms that have shifted the governance system?

Our study, which is based on the Japanese market, contributes to the related literature by providing unique research opportunities to examine firms' decision to voluntarily adopt IFRS in a setting where there are changes to the governance system in a traditionally code-law country, as well as how investors evaluate these decisions. Recently, Barth and Israeli (2013) argue that a key empirical concern for the IFRS adoption literature is how to separate the effect of IFRS adoption from the effect of other, concurrent, regulatory changes. It is true that Japan has experienced various changes in the economic and business environment during the last two decades. To exclude the effects of other events, in our event study analysis, we use a short event window. We also try to control for confounding events in our univariate and multivariate analyses.

The remainder of this article is organized as follows. Section 2 provides a literature review and background information to develop our hypotheses. Section 3 describes the methodology and Section 4 discusses the empirical results. A robustness check and concluding remarks are provided in Sections 5 and 6, respectively.

2. Literature review, background, and hypotheses

2.1. Literature review

Economic theory suggests that a commitment by a firm to increase levels of disclosure should mitigate information asymmetry among investors and adverse selection in capital markets, thereby resulting in increased market liquidity, a reduced cost of capital, and enhanced firm value. Information asymmetry typically generates adverse selection among investors, reducing liquidity in the market. In less liquid markets, firms are likely to issue capital at a discount to persuade potential investors to buy and hold their stocks. Discount issues decrease proceeds to the firms, resulting in higher costs of capital. On the contrary, increased levels of disclosure reduce

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2 A summary of the enormous amount of literature on the main bank system in Japan is provided by Aoki and Patrick (1995), Hoshi and Kashyap (2001), and so on.

3 According to Nomura Securities, the cross-shareholding ratio declined from 30% in the early 1990s to 10.7% in March 2016.

4 Ahmadjian and Robbins (2005) document that the ratio of foreign shareholders increased from 4.2% to 13.2% between 1990 and 2000.

5 Details about the JPX-Nikkei Index 400 are presented at: http://www.jpx.co.jp/english/markets/indices/jpx-nikkei400/.

6 Kim (2016) attempts to address this issue using the Russian experience of mandatory IFRS adoption.

7 Please refer to Verrechia (2001), for example.
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