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ScienceDirect
The International Journal of Accounting
42 (2007) 341 – 379

The International Journal of Accounting

Cross-sectional variation in the economic consequences of international accounting harmonization: The case of mandatory IFRS adoption in the UK ☆

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Abstract

This study examines the economic consequences for UK firms of the European Union's decision to impose mandatory IFRS. We hypothesize that the impact varies across firms and is conditional on the perceived benefit. We estimate a counter-factual proxy for a UK firm's willingness to adopt IFRS from the prior GAAP choices of German firms. We show that this proxy predicts cross-sectional variations in both the short-run market reactions and the long-run changes in cost of equity that are associated with the decision. This implies that mandatory IFRS adoption does not benefit all firms in a uniform way but results in relative winners and losers.

Keywords: International Financial Reporting Standards; Mandatory adoption; Economic consequences

☆ The authors are from the Manchester Accounting and Finance Group, Manchester Business School. We would like to thank Rashad Abdel-khalik, Willem Buijink (our discussant), Kevin Chen, Ole-Kristian Hope, William Rees and other participants at the Illinois Accounting Symposium 2006, an anonymous referee, and Christian Leuz for their valuable comments.
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doi:10.1016/j.intacc.2007.09.007

1. Introduction

The mandatory adoption of IFRS[1] in the European Union (EU) is one of the largest regulatory experiments in financial reporting ever undertaken, and may eventually prove to be a vital step towards global GAAP harmonization.[2] The EU and European Economic Area (EEA) include 30 countries with integrated financial markets and more than 7000 listed firms. Almost all EU/EEA listed firms are legally required to adopt IFRS in their consolidated statements no later than 2005.[3]

In this paper, we examine the economic consequences of mandatory IFRS adoption for United Kingdom (UK) listed firms. We study both the short-term price response to news about IFRS adoption, and the changes in the implied cost of equity for a large sample of firms between a date before the mandatory adoption was expected and a date by which mandatory adoption was effectively certain.

The short-run share-price response and long-run implied cost of equity methods complement each other when testing the effect of mandatory IFRS adoption. The potential advantage of focusing on short-run abnormal returns is that we are able to isolate specific days when news affects all firms in the sample. The disadvantage is that it is reliant on precise identification of the event days. In particular it assumes that there has been no leakage of the policy deliberations to the market. Unfortunately the dates on which the probability of mandatory adoption of IFRS changed are debatable. In contrast, an advantage of using the implied cost of equity method is that it is not sensitive to the identification of specific dates — we simply exclude the period of uncertainty and test the difference between the implied cost of equity before and after the announcement period. However, the estimation of the implied cost of equity is also potentially problematic, because it is often difficult to control for all factors affecting the implied cost of equity over a long period of time. Thus we view the two methodologies as being complementary and we believe that their joint use should increase the robustness of our conclusions.

We hypothesize that UK firms vary in their willingness to adopt IFRS, because the costs and benefits of IFRS adoption are likely to vary across firms. In terms of the literature on accounting choice, the decision to mandate IFRS for UK quoted firms was unusual in the sense that it cannot be simply portrayed as the imposition of a restriction on the accounting choices of UK firms. Prior to 2005 UK firms were not permitted to adopt IFRS for UK financial-reporting purposes. After 2005, UK firms are not allowed to use pre-2005 UK GAAP in their consolidated statements for financial reporting purposes. Thus the EU decision changed the choice set for UK firms by mandating a new set of rules for financial

[1] International Financial Reporting Standards (IFRS) is the name of accounting standards produced by the International Accounting Standards Board (IASB).

[2] The EU's motive for adopting the regulation is the creation of a more transparent and efficient capital market that will facilitate a lower cost of capital for EU firms(EC16/06/2002).

[3] EC 16/06/2002 requires all listed firms in a regulated market to comply with IFRS in their consolidated statements no later than 2005 unless they are listed in non-member state and have been using internationally accepted standards prior to September 2002. Member countries can allow adoption to be postponed until 2007 for firms that comply with US-GAAP. The UK has decided not to use this option and all listed firms in a regulated market are, therefore, required to comply with IFRS from 2005.