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Examining dual accounting systems in Europe☆

Marta Macías *, Flora Muiño

Department of Business Administration, Universidad Carlos III de Madrid, Calle Madrid, 126, 28903 Getafe, Madrid, Spain

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Abstract

After adoption of International Financial Reporting Standards (IFRS) for consolidated financial statements by European-listed companies, a number of European countries still require the use of local standards in the preparation of legal entity financial statements. This study investigates whether this requirement can be explained by a low demand for high-quality financial reporting and an orientation of accounting toward the fulfilment of regulatory needs in these countries. Specifically, using accounting quality as an indicator of the focus of accounting on capital providers' needs, we compare accounting quality between countries permitting and prohibiting the use of IFRS in individual financial statements. Consistent with our expectations, we find that countries requiring the use of local standards in the preparation of legal entity financial statements exhibit a significantly lower level of accounting quality, both prior to and after IFRS adoption. We interpret these results as evidence that these countries have local standards more oriented toward the satisfaction of regulatory needs, rather than investors' needs. Furthermore, since differences in accounting quality persist after the implementation of IFRS, results suggest that firms in these countries face a lower demand for high-quality financial reporting.

Keywords: IFRS endorsement; Accounting quality; Value relevance; Domestic GAAP

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* Corresponding author. Tel.: +34 91 624 9370.
E-mail address: marta.macias@uc3m.es (M. Macías).

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1. Introduction

Diversity in accounting practices has been shown to deter cross-country investment decisions due to the increase in information asymmetries and information costs it entails (e.g., Ahearne, Griever, & Warnock, 2004). Accordingly, harmonization of accounting practices is assumed to reduce barriers to cross-country investments (e.g., Bradshaw, Bushee, & Miller, 2004). Convergence of accounting standards is expected to improve confidence in publicly traded companies, fostering the development of capital markets and thereby promoting economic growth (Hope, Justin, & Kang, 2006). With this aim, in the last decade of the 20th century, the European Union (EU, hereafter) established a new strategy regarding accounting harmonization that crystallized in the requirement of European-listed companies to prepare, since 2005, their consolidated accounts in accordance with International Financial Reporting Standards (IFRS)[1] (Regulation EC 1606/2002).

The mandatory adoption of IFRS in the EU represents one of the largest regulatory experiments ever undertaken (Christensen, Lee, & Walker, 2007). It is based on the assumption that accounting harmonization is a necessary requirement for the globalization of capital markets, as it improves comparability of financial statements.[2] This new regulation has affected approximately 7000 EU-listed companies (CESR, 2007). Regarding legal entity financial statements, however, Regulation EC 1606/2002 allows European Member States to either allow or require companies to follow domestic standards. This is particularly striking, as the European Commission expressed in 1995 (COM 95 (508): 4) that:

> "3.3. [T]he most urgent problem is that concerning European companies with an international vocation. The accounts prepared by those companies in accordance with their national legislation, based on the Accounting Directives, are no longer acceptable for international capital market purposes. These companies are therefore obliged to prepare two sets of accounts, one set which is in conformity with the Accounting Directives and another set which is required by the international capital markets. This situation is not satisfactory. It is costly and the provision of different figures in different environments is confusing to investors and to the public at large."

In addition to the problems of cost and confusion, the Commission also acknowledged that the coexistence of different reporting frameworks deters effective supervision and enforcement of financial reporting requirements of publicly traded companies. This, in turn, harms investors' confidence in listed firms, thus hampering cross-border trade and putting EU securities markets globally at a severe competitive disadvantage.

[1] For purposes of simplicity, we use the term IFRS to refer both to the IFRS issued by the International Accounting Standards Board (IASB) and the International Accounting Standards (IAS) issued by its predecessor, the International Accounting Standards Committee (IASC).

[2] Barth, Landsman, Lang, and Williams (2009) document an increase in comparability between U.S.-GAAP-based and IFRS-based accounting amounts following IFRS adoption, especially after 2005. The importance of harmonization for international valuation and allocation of resources is highlighted in the study by Gómez-Biscarri and López-Espinosa (2008). They show that, at the international level, the Fama and French (1993) three-factor model performs significantly better when using homogeneous information (i.e., IFRS accounting measures).