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Mandatory adoption of IFRS and timely loss recognition across Europe: The effect of corporate finance incentives☆

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ABSTRACT

We examine whether firms have increased their timely loss recognition with the mandatory adoption of International Financial Reporting Standards (IFRS) across Europe since 2005. We estimate firm-specific asymmetric timeliness using the Khan and Watts (2009) C-score, which accounts for size, market-to-book, and leverage. We use firms that voluntarily adopted IFRS before the mandatory adoption date as a control sample to address the effect of unidentified confounding events. We find increased timely loss recognition relative to this control sample only among mandatory IFRS adopters with a higher cost of debt and in countries less dependent on private debt or bank financing. Our results are robust to controls for firm characteristics such as interest coverage, return on assets, earnings volatility, loss, accrual quality, beta, and growth, as well as both industry and country effects. We confirm that corporate finance incentives play a decisive role in determining firms' timeliness of loss recognition after mandatory IFRS adoption.

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1. Introduction

Recent literature on the mandatory adoption of International Financial Reporting Standards (IFRS) across the European Union focuses extensively on the economic consequences of this new accounting regime for the capital markets.[1] These studies generally reveal that mandatory IFRS adoption has a beneficial impact on the capital market, although mainly among countries with better legal enforcement. However, capital market economic consequences are only indirect effects of the change in accounting standards and therefore merely provide indirect evidence of the impact of IFRS. The direct effect of IFRS should be changes in the quality of accounting disclosure, which in turn would provide more direct evidence of the influence of the new accounting standards. Despite this, studies of the mandatory IFRS adoption have so far paid relatively less attention to its effect on accounting disclosure quality and those that do yield mixed findings regarding its benefits.[2]

We examine the impact of mandatory IFRS adoption across Europe on accounting disclosure quality by focusing on timely loss recognition. The inverse relationship between timely loss recognition and costs of debt is well established in the literature (e.g., Ahmed, Billings, Morton, & Stanford-Harris, 2002; Ball, Robin, & Sadka, 2008; Ball & Shivakumar, 2005; Watts, 2003a,b; Zhang, 2008). Timely recognition of loss benefits lenders since it enhances debt contracting efficiency by causing poorly performing borrowers to breach debt covenants in a timely fashion (e.g., Zhang, 2008). However, an inconsistency exists in the existing literature, between the expected and the observed impact of mandatory IFRS adoption on timely loss recognition. Ball (2006) predicts that IFRS will increase timely loss recognition, which will in turn enhance debt

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[1] For example, existing studies have evaluated cost of equity capital (e.g., Daske, Hail, Leuz, & Verdi, 2008; Li, 2010), stock return volatility (e.g., Beuselinck, Joos, Khurana, & Van der Meulen, 2009; Landsman, Maydew, & Thornock, 2012), costs of debt capital (e.g., Florou & Kosi, 2013; Wu & Zhang, 2009), sell-side analyst forecast (e.g., Byard, Li, & Yu, 2011; Tan, Wang, & Welker, 2011), institutional ownership (e.g., DeFond, Hu, Hung, & Li, 2011; Florou & Pope, 2012), and value relevance (Agostino, Drago, & Silipo, 2011). See Leuz and Wysocki (2008) and Bruggemann, Hitz, and Sellhorn (2013) for extensive literature reviews.

[2] For instance, Christensen, Lee, and Walker (2008) show improved accounting quality among voluntary but not mandatory adopters in Germany. Jeanjean and Stolowy (2008) show no reduction in earnings management among mandatory adopters in Australia, France, and the UK.

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contracting efficiency and could therefore reduce the costs of debt capital. Although Florou and Kosi (2013) show that the costs of public debt is indeed lower after the mandatory adoption of IFRS, Ahmed, Neel, and Wang (2013) and Chen, Tang, Jiang, and Lin (2010) both find that timely loss recognition instead declines among mandatory IFRS adopters. In other words, it appears that the direction of the new accounting standards' direct effect (i.e., the decrease in the timeliness of loss recognition) cannot substantiate the direction of its indirect effect (i.e., the decrease in the costs of debt). Therefore, empirical evidence of the decline in both loss recognition timeliness and costs of debt capital, following mandatory IFRS adoption, is difficult to reconcile.[3]

We argue that firms with higher costs of debt are more likely to increase their timely loss recognition following mandatory adoption of IFRS. Our argument is based on three grounds. First, the mandatory adoption of IFRS could render the capital market more sensitive to accounting disclosures than under previous domestic standards. By applying a more consistent set of accounting standards across a large set of countries, IFRS facilitates cross-border financial statement comparability (Ball, 2006). Second, the increased use of financial reports by investors after mandatory adoption of IFRS may lead firms to recognize losses more timely. Prior studies indicate that timely loss recognition is more pronounced when public financial disclosure is a more likely solution for the information asymmetry problem (e.g., Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003). Thus, we would expect companies to recognize economic losses in a more timely fashion, especially when they face greater agency conflicts with debtholders. Third, we expect companies incurring higher costs of debts may exhibit greater increase of timely loss recognition than companies with lower costs of debt in the post-IFRS period due to greater contracting pressure. The mandatory adoption of IFRS provides firms with an opportunity to reduce agency costs of debt by reflecting economic losses in a more timely fashion, particularly for those with greater desire to reduce their costs of capital. The perceived economic benefit is expected to be greater under IFRS than previous domestic accounting standards as the capital market would pay more attention to accounting disclosures under IFRS and the improved cross-country accounting comparability under IFRS facilitates firms to acquire capital from foreign investors. Meanwhile, we also expect that firms with high costs of debt are more likely to increase the timeliness of their loss recognition after mandatory IFRS adoption if they are domiciled in countries with more prevalent public debt markets. One reason is that, between public and private lenders, the former group of investors have higher information costs and are more dependent on financial reporting information (e.g., Bharath, Sunder, & Sunder, 2008; Diamond, 1991; Fama, 1985).

To test our assertion, we apply a sample that comprises 11,860 firm-year observations, from sixteen European countries, over the period from 2002 to 2007. Following existing studies of mandatory IFRS adoption effects (e.g., Byard et al., 2011; Daske et al., 2008; Li, 2009), our treatment sample consists of firms that have adopted IFRS since 2005 on a mandatory basis and our control sample consists of firms that voluntarily adopted IFRS before 2005. If the effect we predict is indeed associated with mandatory IFRS adoption, then it should occur only in the treatment sample. If this effect exists in the control sample as well, then it is likely to be caused by unidentified confounding events or time trends. We measure firm-specific timely loss recognition using the C-score developed by Khan and Watts (2009), which incorporates the effects of size, market-to-book ratio and leverage. Instead of the Basu (1997) regression approach, we use the C-score because it is more likely to capture firm- and time-specific changes in timely loss recognition, which is more appropriate for our research setting. We estimate the firm-specific costs of debt using interest expense divided by total interest-bearing debt, following existing studies such as Pittman and Fortin (2004) and Francis, La Fond, Olsson, and Schipper (2005).[4] Our analyses also control for firm characteristics that may determine firms' incentives to recognize losses on a timely basis as well as both industry and country effects. Finally, we determine the pervasiveness of private debt and bank-based financing among our sampled countries, following the approach of Bushman and Piotroski (2006).

Our findings are as follows. First, using a difference-in-differences research design, we observe that mandatory adopters (treatment sample) with higher costs of debt are associated with incrementally higher C-scores relative to voluntary adopters (control sample) after 2005, when IFRS was enacted. Second, the aforementioned observations exist only among mandatory IFRS adopters domiciled in countries with a lower pervasiveness of private debt or bank-based financing. The results imply that the increase in timely loss recognition that can be attributed to mandatory IFRS adoption depends on firms' corporate finance incentives to reduce the cost of borrowing and on whether the firm is domiciled in countries where public debt is more prevalent.

We contribute to the growing literature on IFRS in three ways. First, we are one of the first studies that argue that accounting conservatism is the means by which the benefit of mandatory IFRS adoption is realized. While many studies have shown that IFRS adoption is associated with lower costs of debt capital (e.g., Florou & Kosi, 2013; Wu & Zhang, 2009), there is little evidence on whether firms change their accounting choices around the adoption of IFRS to alleviate the agency conflicts with debtholders. We show that loss recognition timeliness is one mechanism that firms can employ to address debtholder–shareholder agency conflicts in the post-IFRS period, which is consistent with the prediction by Ball (2006, p. 12). Second, we show that corporate finance incentives play an influential role in determining whether firms commit to higher accounting disclosure quality after their mandatory IFRS adoption, which is consistent with the theory of Leuz (2010, pp. 248–250). While the existing literature provides mixed findings of the impact of mandatory IFRS adoption on timely loss recognition (e.g., Ahmed et al., 2013; Dimitropoulos, Asteriou, Kousenidis, & Leventis, 2013), our study highlights the need to consider the conditioning effect of corporate finance incentives. Finally, we also reconcile the inconsistency in the existing literature, between the expected and the observed impact of mandatory IFRS adoption on timely loss recognition (Ahmed et al., 2013; Ball, 2006; Chen et al., 2010). We show that the decrease in the timeliness of loss recognition after IFRS, documented by concurrent studies (e.g., Ahmed et al., 2013; Chen et al., 2010), is caused by a background time trend and not mandatory IFRS adoption.

Our paper is organized as follows. Section 2 reviews the relevant literature and develops the hypotheses. Section 3 describes the methodology, sample, and data. Section 4 presents the empirical findings. Section 5 concludes.

2. Literature review and hypothesis development

2.1. Timely loss recognition and the costs of debt

Higher accounting disclosure quality decreases information asymmetry, which in turn lowers lenders' perceived risk and reduces adverse selection problems (Verrecchia, 2001). When lending money to firms, investors need to assess the default risk of borrowers, based on all available information. Capital suppliers are likely to perceive firms that withhold information and have greater information uncertainty as riskier and therefore charge a higher premium to compensate (Diamond & Verrecchia, 1991). Accounting information is used in debt covenants

[3] Florou and Kosi (2013) sampled 21 countries and Ahmed et al. (2013) sampled 19 studies. The samples of these two studies overlapped by 18 countries. Therefore, it is unlikely that the differences in their results are driven by differences in the countries sampled.

[4] We use this measure because it enables us to cover a much larger sample size than other measures such as yield spread from bond issues or syndicated loans would allow. These alternative measures are often limited by data availability and could also incur sample selection bias. For instance, Dealscan has a greater coverage of syndicated loans for the US than for European firms.

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