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Does transition to IFRS substantially affect key financial ratios in shareholder-oriented common law regimes? Evidence from the UK

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ABSTRACT

This paper provides evidence of how a transition to IFRS affects key financial ratios and the pertinent financial statement items. Building on Lantto and Sahlström's (2009) evidence from creditor-oriented code law regimes, we examine the impact of IFRS transition on listed companies in the shareholder-oriented common law regime of the UK. The study contributes two insights: First – despite their similarities – conversion from the UK General Accepted Accounting Principles (GAAP) to IFRS leads to substantial differences in key financial ratios. These even surpass differences reported by companies in creditor-oriented code law regimes. We find that medians of profitability ratios increased substantially: Operating Income Margin (OPM) increased by 10.8%, Return on Equity (ROE) by 27.0%, and Return on Invested Capital (ROIC) by 14.4%. The Current Ratio (CR) and Price-to-Earnings (P/E) Ratio also exhibit significant but less drastic changes of 4.2% and −2.9%, respectively. Second, differences in shareholder-oriented common law regimes have the same causes as in creditor-oriented code law regimes, i.e., an increase in Operating Income, Net Income, Current Liabilities and Invested Capital, as well as a decrease in Shareholder Equity.

1. Introduction

From the financial year starting January 1, 2005, all EU-listed companies have been obliged to publish consolidated financial statements based on EU-endorsed International Financial Reporting Standards (IFRS).[1] The main goal of this change was to improve the quality of information in financial statements for capital market participants and to increase international comparability (Jones & Finley, 2011). As an obstacle to this transition, substantial differences were detected between IFRS, and many domestic accounting standards (DASs) despite the attempt to reach early convergence by local standard setters (Zeff, 2007).

Current research identifies the largest differences between IFRS and the DASs originating from 'creditor-oriented' code law regimes, meaning that on an international average, companies in these legal regimes rely more on debt financing. The reason for this is that IFRS are more oriented towards providing information relevant to capital market participants than to creditors like banks. On an international average, IFRS resemble DASs originating from shareholder-oriented common law regimes. Companies in these countries rely relatively more on equity-financing (Haller & Walton, 2003; Lueg, 2008a; Nobes & Parker, 2010; Zeff, 2007). Companies switching from DASs in shareholder-oriented common law regimes such as the UK should therefore exhibit fewer differences in financial statements after an IFRS transition (Aisbitt, 2006; Byard, Li, & Yu, 2011; Cairns, Massoudi, Taplin, & Tarca, 2011; Dunne et al., 2008; Lantto & Sahlström, 2009). Only scant empirical evidence suggests how such a transition affects the key financial ratios of companies. Yet, more insight would be of utmost importance for the users of financial statements. Goodwin, Ahmed, and Heaney (2008) provide evidence that the transition to IFRS in Australia did have a substantial impact on financial ratios, as do Stent, Bradbury, and Hooks (2010) for New Zealand. In the UK context, Christensen, Lee, and Walker (2009) show that IFRS adoption by UK-listed companies provides new information to the market, which gives rise to the conjecture that the conversion from UK GAAP to IFRS is not a neutral translation. Such an evolution in accounting standards is of interest to users of financial information. These include analysts, investors and financial institutions that either assess the performance of UK companies over time or form expectations about companies in other jurisdictions, such as the United States (Clatworthy & Jones, 2008; Lueg, 2008b; Maroney, McGarry, & Ó hÓgartaigh, 2008; Oliveira, Rodrigues, & Craig, 2010). Financial ratios and the underlying changes in financial statement items are of special interest to a broad

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[1] Postponement until 2007 was an option in the regulation for companies issuing only debt instruments but not equity instruments, or publishing statements under another set of internationally accepted accounting standards (for example US GAAP). The UK did not take this option.

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range of analysts. First, these stakeholders rely on aggregated accounting numbers for their investment decisions. Second, such 'functional fixation' on ratios can bias their judgment if these ratios change only due to a transition in accounting standards (Clark-Murphy & Soutar, 2004; Ghani, Laswad, & Tooley, 2011; Lipe, 1998; Ou & Penman, 1989). Especially Vergoossen (1997) provides conclusive evidence that most users of financial statements do not notice evolutionary changes in accounting policies. We use the UK as a prominent example of a shareholder-oriented common law regime and address the research question:

RQ1 Does transition to IFRS substantially affect key financial ratios in the UK, and if so, what are the underlying reasons for this?

Our paper deals with this question by assessing differences in key financial ratios of companies listed in the shareholder-oriented common law regime of the UK. Building on Lantto and Sahlström's (2009) findings from a creditor-oriented code law regime (Finland), we follow their three-step approach to test whether key financial ratios under UK GAAP differ substantially from those under IFRS: First, we create a database from reconciliation reports exhibiting financial information under UK GAAP and under IFRS. Second – as the main objective of our study is to contribute relevant information to the users of financial statements – we investigate whether or not key financial ratios reported concurrently under UK GAAP and IFRS differ and whether the difference is statistically significant. Third, we analyze the underlying changes in financial statement items.

We choose to investigate UK-listed companies for two reasons: First, current research regards both common-law-based DASs and IFRS as capital-market-oriented accounting systems and asserts that a transition will cause less substantial differences in financial statement items and key financial ratios than in creditor-oriented code law countries (Ding, Hope, Jeanjean, & Stolowy, 2007, p. 9; Lantto & Sahlström, 2009, p. 344). Second, UK companies are distinctly oriented towards shareholders. Besides Australia (Goodwin et al., 2008), the UK is the largest common-law-based economy that underwent a mandatory adoption of IFRS (Nobes & Parker, 2010), which avoided a self-selection bias in our study.

The results of this study indicate substantial changes in the medians of financial ratios after the conversion from UK GAAP to IFRS. Their patterns are consistent with Lantto and Sahlström's (2009) results from the less shareholder-oriented code law regime of Finland. More surprisingly, some changes have an even larger magnitude in the UK than in Finland. We find that medians of profitability ratios increase substantially: Operating Income Margin (OPM) increases by 10.8%, Return on Equity (ROE) by 27.0%, and Return on Invested Capital (ROIC) by 14.4%. The Current Ratio (CR) and Price-to-Earnings (P/E) Ratio also exhibit significant but less drastic changes of 4.2% and −2.9%, respectively. These findings are consistent with those of Goodwin et al. (2008), who observe the mandatory transition to IFRS in Australia. Using a similar methodology, our remaining findings are largely consistent with theirs, and statistically even more significant.

We find several reasons for these changes in key financial ratios by investigating the medians of financial statement items: First, the change in OPM is caused by the change in Operating Income, which increased by 20% after the conversion from UK GAAP to IFRS. Second, the increases in ROE and ROIC, and the decrease in P/E ratios are – to a high extent – driven by an increase in Net Income (29%). The effect for ROIC is partly set off by a slight – but highly significant – increase in Invested Capital (+1.2%). Third, we explain the increase in the CRs with significant increases in Current Liabilities, while there is no statistically significant change in Current Assets. Hence, the reasons for the changes in key financial ratios in the UK are consistent with previous results from creditor-oriented code law regimes, e.g., Finland (Lantto & Sahlström, 2009).

2. Hypothesis development

Practical implications and (dis-)advantages of IFRS adoption have been thoroughly discussed, also with a specific focus on the UK context (Armstrong, Barth, Jagolinzer, & Riedl, 2010; Daske, Hail, Leuz, & Verdi, 2008; Dunne et al., 2008; Li, 2010; Soderstrom & Sun, 2007). We now discuss general conjectures arguing that differences in financial statement items and key financial ratios resulting from IFRS adoption should be smaller in shareholder-oriented common law regimes than in creditor-oriented code law regimes.

2.1. General differences in accounting standards

The contemporary literature suggests that the main cause of differences in DASs is the provision of finance to companies. A second reason concerns the legal system of a country. Last, there are several other, weaker factors coinciding with differences in DASs, e.g., culture, and the relevance of financial statements for taxation purposes. Overall, these factors all imply that IFRS are generally more similar to shareholder-oriented common law DASs than DASs from creditor-oriented code law regimes (Alexander, Britton, & Jorisson, 2009; Haller & Walton, 2003; Nobes & Parker, 2010). We will give a short overview as well as a critique on these differences.

2.1.1. Provision of finance

The difference in providers of finance is the key cause of international differences in financial reporting, i.e., creditors versus investors (Alexander et al., 2009; La Porta, Lopez de Silanes, Shleifer, & Vishny, 1998; Nobes & Parker, 2010). Since companies in countries like Finland, Germany, France, Italy and Belgium have traditionally relied on debt as a main source of financing, banks have become the major supplier of funds. These stakeholders receive information directly from management, or may even participate in firm decision making through board membership (Hope, 2003). Their focus is on threats rather than on opportunities, which is reflected in the financial statement information requested by creditors.

Contrary to this, companies from North America or the Commonwealth have traditionally relied on equity financing. They hence face external demand for information on firm performance (d'Arcy, 2001). Ding et al. (2007) and Hope (2003) show empirically that the quality of financial accounting information from a shareholder perspective is generally higher in countries where companies traditionally rely on equity financing. They argue that, DASs will be similar to IFRS in settings with highly developed equity markets. We should hence find weaker effects of the transition of UK GAAP to IFRS than Lantto and Sahlström (2009) found for companies listed in Finland.

2.1.2. Tradition of legal system

The traditions of the existing legal systems in various countries constitute the second, crude differentiation of financial accounting (Alexander et al., 2009; Haller & Walton, 2003; Holthausen, 2009; Nobes & Parker, 2010; Soderstrom & Sun, 2007). The code law system originated from Roman law and has developed in Continental Europe, e.g., Finland and Germany. This system is characterized by a wide set of rules, providing guidance for any given legal problem. Due to this, company law is relatively detailed, and moreover, regulated by governmental agencies (Dunne et al., 2008; Fifield, Finningham, Fox, Power, & Veneziani, 2011; Nobes & Parker, 2010; Zeff, 2007).

In contrast, the common law system, which originated in the UK, has developed case by case and does not offer universally applicable rules. In this context, accounting regulations are not directly set by government agencies but through professional bodies in the private sector (Dunne et al., 2008; Nobes & Parker, 2010). This implies a lower degree of regulation and the necessity for individual judgment. IFRS are set by the International Accounting Standards Board (IASB) and hence fall in this latter category.

Nobes and Parker (2010) note an obvious correlation between equity financing, common law, and similarity to IFRS. For instance, they show that the ratio of listed companies per capita in the UK (common law) is almost five times as high as in Germany (code law). Yet, they