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Financial statement effects of adopting international accounting standards: the case of Germany

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Abstract

Using a sample of German firms, we investigate the financial statement effects of adopting International Accounting Standards (IAS) during 1998 through 2002. We find that total assets and book value of equity, as well as variability of book value and income, are significantly higher under IAS than under German GAAP (HGB). In addition, book value and income are no more value relevant under IAS than under HGB, and HGB (IAS) income is highly persistent (transitory). Finally, we find weak evidence that IAS income exhibits greater conditional conservatism than HGB income. Our results are consistent with the

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Notes

1. For ease of exposition, we use the term "IAS" to refer to both the International Accounting Standards (IAS) issued by International Accounting Standards Committee (IASC) and the International Financial Reporting Standards (IFRS) issued by IASC's successor, the International Accounting Standards Board (IASB).

2. For ease of exposition, henceforth we use "HGB" to refer to either German GAAP or the

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the auditing and implementation environment in Germany. In April 1998, section 323 of HGB increased the legal liability for auditors, and sections 331–332 of HGB subjected auditors and directors to criminal prosecution.

4. More than 40% of the companies in the German DAX100 index have adopted IAS and many companies are planning to do so in the near future (Leuz and Wustemann 2004). This trend is partially due to the enactment of the Capital Raising Facilitation Act (KapAEG) in 1998, which allows German listed firms to prepare their consolidated financial statements according to internationally accepted accounting standards instead of German accounting standards.

5. For example, the core standards were the standards being considered for endorsement by the International Organization of Securities Commissions (IOSCO). The endorsement of IAS by IOSCO was one of the key factors for the European Commission's decision to adopt IAS.

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current prices for the value relevance and asymmetric timeliness tests.

7. While the majority of the core standards have effective dates earlier than 1998, few of the standards have effective dates later than 1998. However, we note that the standards generally encourage early adoption.

8. Before the revised IAS 1 became effective in 1998, there was no requirement that IAS adopters should be in full compliance with IAS and many "IAS adopters" selectively adopted standards between local GAAP and IAS in their financial statements. Specifically, the revised IAS 1 states: *"Financial statements should not be described as complying with International Accounting Standards unless they comply with all the requirements of each applicable Standard and each applicable interpretation of the Standing Interpretations Committee."*

9. We note that in addition to "DI," there are two other accounting standards codes in Compustat Global with references to IAS:

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German companies in Compustat have the accounting codes "DA" or "DT" during our sample period.

10. One firm's accounting standard codes change from "DS" to "DU" and then to "DI" during our sample period, where "DU" denotes "Domestic standards in accordance with principles generally accepted in the United States." We check the accounting standards in the company's annual reports throughout our sample period. We find that the codes "DU" should have been "DS" and make the corrections accordingly.

11. While verifying our data, we ensure that the reported financial statement numbers in the annual reports are the same as those reported in Compustat Global and that we do not erroneously classify a firm as an IAS adopter during our sample period. However, we acknowledge that it is possible that there are firms that did adopt IAS during our sample period but are not included in the sample because of errors in the Compustat Global database and our reliance

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reasonably determined. We note that SIC 8 was superseded by IFRS 1 (First-Time Adoption of International Accounting Standards) in 2004.

13. We illustrate our procedure by using BMW as an example. BMW adopted IAS for the first time in 2001 (see Appendix 1 for excerpts from BMW's 2001 Annual Report). In its 2001 Annual Report, BMW reports the 2001 financial statements according to IAS and restates the 2000 financial statements as if prepared in accordance with IAS. Since the 2000 financial statements reported in its 2000 annual report are based on HGB, we are able to obtain both HGB and IAS data for 2000.

14. We note that while firms with a book value or net income reconciliation likely differ from those without a reconciliation in terms of firm size or investor base, we do not expect the differences to affect our overall inferences: Our conclusions regarding accounting differences are based on the interpretation of the accounting standards.

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provide such information on the ending balance of book values. Thus, the reconciliation adjustments reported in Panel A of Table 3 do not necessarily pertain to the same years used in our primary analyses.

16. While companies might include these items in the “other adjustments” category, we assume items included in this category are generally immaterial.

17. Since the descriptive statistics in Panel A of Table 3 are based on a subset of our sample, we do not report the statistics tests on the differences between book value and net income in this panel. We report results from such statistical tests for our full sample in Panel B of Table 3.

18. Note that lease capitalization creates compensating assets and liabilities on the balance sheet. The increase in book value likely occurs because the capitalized assets exceed the liability, which usually happens in the later stages of the lease for the lessee

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capitalized goodwill but also on the amortization schedule.

20. While we have 84 observations for book value of equity and net income, we only have 81 observations for other key accounting numbers. This is because we are not able to obtain restated total assets, total liabilities, and sales revenue numbers from book value and net income reconciliation adjustments. (Recall that in the sample selection description, we gather three additional observations on book value of equity and net income from firms that disclose two-year book value and net income reconciliations.)

21. While income under fair-value accounting is less persistent and hence unlikely to correlate better with stock prices, it can be argued that it measures the change in the value of net assets of the firm and should therefore correlate better with returns. Therefore, it also could be argued that income under fair-value accounting is more value relevant in the sense of explaining

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no differences in relative value relevance. Therefore, our incremental value relevance tests provide additional evidence that cannot be inferred from the relative value relevance analyses.

23. We replicate our analysis for alternative truncation rules that are less stringent, including the full sample (i.e., without truncation). Our results (not reported) are qualitatively similar in these replications, although statistical significance is lower, as might be expected. Most of our analyses have low power because of the relatively small sample sizes in our paper compared with typical market-based analyses.

24. The Vuong (1989) statistic has been used extensively in accounting research to test for significant differences in R^2 across different regressions. The Vuong (1989) test is a likelihood-ratio test of non-nested difference in explanatory power between two models, under the null hypothesis that either model is "true." The only two requirements of the test are that the

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regressions and normality. Accordingly, we apply a bootstrapping approach as an alternative significant test and find that our results are qualitatively unchanged (see Sect. 7.4).

26. To corroborate the result that IAS income is less persistent, we examine first-order autocorrelation in income before and after IAS adoption by our sample firms. Consistent with our pattern of pricing coefficients, we find that the autocorrelation in income drops significantly after adoption of IAS, suggesting that income under IAS is significantly less persistent.

27. Cramer (1987) shows that the standard error of R^2 for a sample of 60 and 4 regressors and a "true" R^2 of around 0.33 is about 0.10. Under these distributional assumptions, the R^2 differences between IAS and HGB that we report are unlikely to be statistically significant given our sample size and the R^2s for IAS and HGB.

28. While speculative, our evidence is

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subject to the alternative explanation that our tests lack power to detect differences in asymmetric timeliness across the two systems.

29. We choose eight months after the fiscal year-end because German companies are required to report their annual earnings to the public within eight months of the fiscal year-end (Alford et al. 1993). Thus, examining eight months after the fiscal year-end of the following year ensures that both IAS and HGB information is available to the stock market.

30. We also note that prior studies have not been able to document that firms significantly change their accounting reporting behavior before cross-listing in the United States or adopting IAS. For example, Lang et al. (2003, Footnote 11) do not find significant changes in accounting quality over the two years before cross-listing. In addition, if our sample firms voluntarily adopt IAS to signal increased accounting quality, it is unclear that these

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inherent stability, it is easier to examine the effects of accounting changes.

32. The exceptions are as follows: (1) the difference in the book value coefficients under IAS and HGB in Panel A of Table 5 becomes significant at only $p = 14\%$ (two-tailed); (2) the coefficient on book value adjustments in Panel B of Table 5 becomes significant at only $p = 16\%$ (two-tailed); and (3) the coefficients on the interaction terms between RET and NEG in Table 6 become insignificant at conventional levels under the HGB income model.

33. We note that this analysis is based on a sample of 60 observations due to missing values in lagged market values. Thus, the loss of significance could result from the relatively low power in the reduced sample. Additional analysis restricting the tests in Tables 5 and 6 to the subsample with available lagged market values indicates that the significance levels are lower. Specifically, the analysis (not tabulated) shows that (1) the difference in book value

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Appendix 1

Case 1: Excerpts from the notes to the group financial statements in the BMW 2001 Annual Report

[1] Basis of preparation

The consolidated financial statements of BMW AG (“BMW Group financial statements” or “Group financial Statements”) at 31 December 2001 have been drawn up for the first time in accordance with the standards valid on the balance sheet date issued by the International Accounting Standards Board (IASB), London. All International Accounting Standards (IAS) and interpretations of the Standing Interpretations Committees (SIC) which were mandatory for

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the conversion to IAS has been treated as an adjustment to the opening balance of equity...

Equity

Equity under IAS increases by euro 4,536 million (+92.6%). The following summary shows the recognition and measurement differences between HGB and IAS and reconciles the equity at 31 December 2000 under HGB to the equity on the first day of the following year, 1 January 2001, under IAS:

The net profit under IAS is euro 183 million (+17.8%) higher than under HGB. The net profit for IAS and HGB is reconciled as follows:

Case 2: Excerpts from the notes to the group financial statements in the Washtec 2001 Annual Report

Financial statements

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compliance with EU Directive 83/349/EWG on consolidated financial statements.

No accounting and valuation methods under German law were applied which are not compliant with IAS or SIC.

The requirements of section 292a of the German Commercial Code (HGB) for release from the obligation to draw up consolidated financial statements under the HGB are satisfied. Evaluation of these requirements is based on the German Accounting Standard No. 1 (DRS 1) published by the German Standardisation Council.

The previous year's consolidated financial statements were drawn up under the HGB regulations, and the financial statements in the year under review are the first to be drawn up under IAS regulations...

Conversion of shareholders' equity presentation to IAS:

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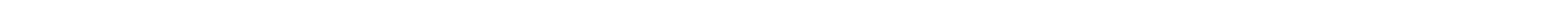

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