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FACULTY OF ECONOMICS AND BUSINESS ADMINISTRATION
CLUJ-NAPOCA

PhD THESIS

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2024

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A study of how the qualitative characteristics of financial statements are influenced by the International Financial Reporting Standards

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KEY-WORDS

IFRS,

Comparability

Western Europe

Eastern Europe

Accounting quality

Summary

Ever since 2005, when IFRS standards became mandatory for all publicly listed companies, there have been tremendous discussions with supporters stating that accounting quality and comparability of financial statements improved after companies started to use a single set of standards, while opponents arguing that a single set of standards cannot eliminate all the political and economic differences between the different companies located in different jurisdictions; their idea being that the financial statements are directly influenced from several other factors than a unique set of accounting regulations. Moreover, despite several attempts for a standardized understanding, it was shown that an IFRS standard can be interpreted and implemented in different ways resulting in differences in how financial statements can be viewed by different stakeholders.

The thesis, "A study of how the qualitative characteristics of financial statements are influenced by the International Financial Reporting Standards", is a comprehensive research focusing on how the IFRS implementation has met the initial objectives stated by the IASB. The research is focused on how the differences between Eastern European companies and Western European ones, in terms of financial statements discrepancies, changed after IFRS implementation.

The major objective of the paper is to find out whether comparability has increased after the IFRS implementation. Higher confidence in these standards can be achieved just by having evidence of better performance and accuracy after implementation. An important element for the actors of the capital market is to find out whether standardization in financial reporting is achieved or if there is still place for different interpretations and application of the standards. Standardization should be seen in this case as a measure of improved comparability, higher value relevance, higher accounting quality, reduced cost of capital, or higher number of foreign investors.

The thesis is divided into three main parts:

The first part presents the theoretical basis, the IFRS Conceptual Framework. The summary of this document is presented, highlighting the main objectives that are assumed to be

achieved once IFRS are implemented. These objectives are analyzed in the next sections to conclude whether they are met in practice or not.

The second part presents a literature review, highlighting the conclusions of more than 80 studies done on related subjects after 2005. This part is split into sub-sections analyzing results for each of the initial objectives: comparability, value relevance, accounting quality, and capital market benefits. It aims to provide the current overview of the literature regarding the effects of IFRS implementation, clustering together different results archived through different research methods from surveys to empirical analysis.

The third part is the actual research. The questions I addressed are:

Q1: Is financial statements comparability between Eastern European firms and Western European firms higher after Eastern European ones adopted IFRS?

Q2: Does the value relevance of financial statements become similar for Eastern and Western European companies after IFRS adoption?

Q3: Does the accounting quality of financial statements become similar for Eastern and Western European companies after IFRS adoption?

Q4: Did stakeholders invest more in Eastern European firms after IFRS adoption?

The research starts with a literature review to check the current status of the studies in the field. A thorough analysis of the most recent researches has been done on the comparability of financial statements, value relevance, accounting quality and capital market benefits and it derives the following takeaways:

- Generally, for countries less developed it is clear that the implementation was not done similarly, often being more “symbolic” than a real change process, while for the developed ones was easier to embrace IFRS regulations, due to the already existing quality in their financial statements.

- Moreover, results indicate differences between countries with high enforcement and those with low one. It was revealed that the period of IFRS adoption might take in reality more than three years and for some countries, the results were mixed, initial expected effects not always being visible.

• Regarding effects on comparability, results point out that there is an increase in comparability between companies that adopt IFRS. Also, the gap between companies that choose not to adopt IFRS is increasing in terms of comparability.

• Effects on value relevance after IFRS implementation are generally showing an increase in the value relevance of equity book value and earnings is observed, while the relevance of earnings and changes in earnings is not significantly improved. The most interesting finding is that it appears that domestic / European directives have influenced more the value relevance of financial statements than the adoption of IFRS itself.

• Effects on accounting quality are not expected to be significant, as the majority of the studies showed that the intended effects of the IFRS framework are overtaken by the diverse legal or political structures in the European space. However, voluntary IFRS implementation paves the way to a decline in earnings management, and to an increase in value relevance and timely loss recognition

• Regarding effects on capital market benefits, an improvement is generally seen for the companies that adopt voluntary IFRS or the ones from jurisdictions in which IFRS adoption is high.

The second part of the thesis consists of an empirical research focused on checking the effects of IFRS implementation on a sample of companies from 24 countries in Western and Eastern Europe from several industries. The research design is adapted from Barth et al. (2012) and Barth et al. (2017) and is focusing on checking how comparability, value relevance, accounting quality, and capital market benefits differences between the two groups of countries changed after IFRS implementation. The tests were applied twice – once before IFRS adoption and then after IFRS adoption, to be able to state whether comparability between financial statements from WE countries and those from EE countries has increased after IFRS adoption. Moreover, several other subsamples were created and the tests were applied to them as well (industry sector, number of years after adoption, financial crisis years isolated, representative countries directly compared). The subsamples are relevant to check whether significant differences can be observed in how different industries or countries reacted to IFRS implementation in different periods The start hypotheses was that for all the subjects an improvement can be seen and the difference between WE and EE decreases after the adoption, the conclusions being as follows:

For the first question stated above “Is financial statements comparability between Eastern European firms and Western European firms higher after Eastern European ones adopted IFRS?” it is concluded that the comparability of financial statements between WE and EE companies has improved significantly after IFRS adoption, and investors can make better-informed decisions regarding placing their capital due to the below reasons:

- For the entire sample a reduction in the differences can be seen only for stock prices, while return and cash flow remain constant. The argument that there is an influence from the economic crisis is proved and by taking out the years 2008 and 2009 all three indicators have a significant decrease in the differences between WE and EE (stock prices reduce by more than 50%, while return and cashflow are almost zero). Even more, the results are also confirmed after five years of IFRS adoption. For EE there is a bigger improvement from 2005 until 2011 (w/o 2008-2009) which is normal as it is the first impact of adopting new standards, while for WE there is not such a significant change in the first years, but still the downward trend regarding differences can be seen in 2012-2017.

- For the industry level, the results show a greater comparability between WE and EE. For two industries (basic materials and industrials) the improvement is shown in all three indicators, while for one (consumer cyclicals) is shown in two out of three. For the last one (financials) only cash flow is improving. However, the results in EE companies improved more than the ones in WE, confirming the reasoning that in WE the information from the financial statements was at a level closer to IFRS standards requirements. Overall, also at the industry level the hypothesis is confirmed.

- For the country-level analysis all three indicators have smaller differences after IFRS implementation, resulting in greater comparability.

The second question is whether the value relevance of financial statements become similar for Eastern and Western European companies after IFRS adoption. To be able to answer it, the entire sample was analyzed as well as different subsamples to check my initial hypothesis. In the first subsample, years 2008 and 2009 were taken out to isolate the potential effects of the economic crisis from the changes that appeared because of the IFRS implementation. However, it was assumed the same effect in value relevance willl not be visible as it was in comparability. It was expected that the economic crisis did not impact so much the value relevance as explained at the beginning of the section. Secondly, it was analysed on industry level to check whether the effect was more significant in some economic sectors. Next comes the analysis of the most representative countries of the sample and finally, it was checked if there is a major change in the results after five years of IFRS implementation. The five-year benchmark was used as it was considered that in this period companies had the chance to adapt and familiarize themselves with all the details. The overall conclusions are the following:

- As expected for both the entire sample and the sample without years 2008 and 2009 the results are similar: all three indicators have a reduced difference between WE and EE after IFRS implementation. In the first five years of IFRS adoption, the improvement in value relevance between WE and EE was significant, while in the subsequent period 2012-2017, not much improvements could be seen. Still, the differences were smaller than in the NON-IFRS period.

- For all industries, the difference in returns decreased after IFRS implementation, and for two out of four industries stock price (consumer cyclicals and basic materials) or cashflow (industrials and financials) also decreased. The reason why a decrease is not visible in all the observations is that for WE the impact of IFRS adoption was insignificant. For EE companies all three indicators improved.

- For the country-level analysis, the improvement in value relevance after IFRS implementation is confirmed for all three indicators.

In conclusion, it can be stated that the hypothesis is confirmed: the value relevance of financial statements between WE and EE companies has improved significantly after IFRS adoption, with investors being able to have access to information of higher value of use.

For the third question in regards with accounting quality, three different perspectives were analyzed: earnings smoothing, accruals quality and timeliness. For all the three, all metrics were confirmed only after five years since IFRS adoption. This result is in line with the related existing literature, confirming once again that full adoption takes more than three years.

The final question analyzed whether the capital market benefits improved after IFRS implementation. The liquidity and share turnover behavior were taken into consideration one year before adoption, one year after adoption, and five years after adoption.

For the liquidity analysis, two metrics were studied: AMIHUD and ZeroRet. The results are consistent for both of them, confirming the initial hypothesis that after IFRS implementation, the liquidity of the companies increased. The results show a bigger impact, as expected, on the EE companies. However, improvements are seen also for the WE companies. It is worth mentioning that also the difference between WE and EE decreased after IFRS adoption.

Moreover, results show that early adopters benefit from greater improvements. For the companies that adopted IFRS in 2004, as a preparation for the mandatory adoption in 2005, results after five years do not show exclusively the effects of the standards adoption, because of the economic crisis effects.

When it comes to share turnover, a high one indicates that it is easier for investors to buy or sell the shares of that company in the open market. The analysis done shows that there was almost no effect of IFRS adoption on the share turnover for EE and WE companies. A slight improvement can be seen for the 2004 adopters after five years of adoption. The results are surely influenced by the economic crisis and the period afterward when the investors were more continent when it came to trading shares.

The purpose of the empirical research was to confirm that after IFRS adoption, differences between WE and EE companies have decreased and investors are more confident to invest their capital in EE than before. The initial hypotheses were confirmed, with one exception: the share turnover analysis was not significant enough to state a conclusion. However, it is clear that initial objectives of IFRS implementation, as stated by the Conceptual Framework, are achieved in practice even if research shows that it takes more than three years to fully comply with the standards. For sure differences in achieved effects exist due to several external factors such as general economic environment, political situation of each country, or domestic laws.

However, the biggest economical events other than IFRS adoption were eliminated from the analyzed sample, so that the results would reflect the effects of IFRS. In this regard, the data for all the parts without 2008 and 2009 was analyzed without the effects of the economic crisis. Moreover, the majority of the sample are companies from countries that joined European Union before or in 2004. This means that the analysis done after 2005, isolates the effects of the EU admission.

One limitation of the thesis that should be taken into account is sample selectivity. Because of the limited number of companies for EE with available data for the years needed, the EE sample might be considered to be more selective than the WE one. However, through the matching procedure used, the effects of the selectivity were eliminated as much as possible.

The thesis could be further extended in order to check in a more detailed level how the most important standards are applied in both regions and if significant differences still exist. A thorough analysis can be done on standards such as IAS 2 (Inventories), IAS 36 (Impairment of Assets), or IAS 39 (Financial Instruments: Recognition and Measurement) as they represent important concepts that define the comparability of companies. Moreover, when it comes to capital market benefits, share turnover can be further analyzed by using a bigger country level sample, that could indicate significant changes after the years when the economic crisis effects disappeared.

In conclusion, throughout the thesis it is clearly shown that the initial objectives of IFRS implementation are achieved in practice, even if not as early as initially considered. The difference between Eastern and Western Europe comparability of financial statements is reduced, higher confidence of the investors in these statements being achieved. As expected, several external factors are influencing the significance of the IFRS adoption effects; however, improvements are clearly seen.