

## **The Adoption of IFRS in the UK**

June 2008

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## **Abstract**

There are two approaches which investors can exercise when using accounting information are commonly discussed, either to the use of financial reporting to value the company or the use of financial reporting to assess the management's stewardship of the company. Despite the fact that US GAAP, IFRS, and UK GAAP are all market oriented sets of accounting standards, both FASB and IASB are more inclined to require fair value accounting with regards to assets and liabilities compared to UK GAAP, which tend to a greater extent to encourage the stewardship approach. We examine whether investors' shift their focus from earnings to book value of shareholders' equity after the adoption of IFRS in the United Kingdom. As predicted we find that indeed investors seem to rely more on the book value of shareholders' equity and less on earnings information after the adoption of IFRS. We predicted and found no change in the overall increase accounting information's ability to predict future equity values.

## 1. Introduction

We examine the change in financial reporting's ability to predict equity values before and after adoption of International Financial Reporting Standards (IFRS) in the United Kingdom (UK). As of January, 2005, all publicly traded companies European Union (EU) members have to comply with the IFRS on consolidated level.<sup>1</sup> Focusing on the UK, we investigate both the overall impact on the ability to predict equity values and the reliance on earnings and shareholders' equity. The EU regulation was designed to increase the usefulness of financial information by ensuring greater consistency and quality.

We contribute to the existing literature by documenting the effects of adopting an equity-market oriented set of accounting standards (IFRS) in a country (the UK) already known for its equity-market orientated accounting standards. We use the framework of Ohlson (1995, 1999) and Feltham and Ohlson (1995, 1996) to study and compare the ability of financial reporting to predict equity values under UK Generally Accepted Accounting Standards (GAAP) and IFRS. This framework links equity values and accounting numbers and make it possible to assess the usefulness of accounting numbers to investors.

UK accounting has tended to focus on the importance of the management's stewardship compared to United States (US) and IFRS, which are more geared towards valuation. Recently, there has been a steady development towards fair value valuation and a focus on the balance sheet in the development of US accounting standards and IFRSs (Weetman et al. 1998; Penman 2007). This development has also had an impact in the UK; however, the reluctance to impose too uniform standards has resulted in less of a focus on the balance sheet. One example of this is the

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<sup>1</sup> Regulation (EC) No. 1606/2002

development of standards for accounting for deferred tax in the UK. Neither Statement of Standard Accounting Practice (SSAP) 11 nor SSAP 15 explicitly specified the use of a certain method, which made it possible for companies to use either the deferral method or the liability method for computation of deferred tax (Hope and Briggs 1982). Finally, the FRS 19 issued in 2000 required the use of the liability method. However, in spite of the fact that UK GAAP now requires something very similar to US GAAP standards and IFRSs, FRS 19 prescribes recognition of deferred tax based on obligations arising as opposed to International Accounting Standard (IAS) 12, which prescribes recognition based on temporary differences. That is, under FRS 19, the UK is still maintaining an income statement approach and less of a fair value approach (Alexander and Britton2004).

We predict that financial reporting under IFRS will not be more value relevant compared to financial reporting under UK GAAP. However, we do predict that the adoption of IFRS results in a shift in investors' focus on the different components of the reported accounting numbers. Specifically, we predict and find that investors are relying more on book value of equity than the income statement when firms reports under IFRS compared to when they report under UK GAAP. Using data from all UK companies with Worldscope accounting data on between 2003 and 2006, we find that investors rely more on book value of equity and less on earnings numbers after the adoption of IFRS.

The remainder of this paper is organized as follows. The next section provides a discussion about the development of UK accounting standards and practices over time. The third section offers a discussion on previous research linking accounting measures to equity values. This is followed by a section describing the research design. The fifth section shows the data used and descriptive statistics. The sixth

section discusses the results of our tests and the last section provides a summary with concluding remarks on the implications of the study.

## **2. Accounting in the United Kingdom**

Formal accounting regulations have been around since 1844 in the UK (Aisbitt, 2002). However, since then regulation has developed requiring an increased disclosure by companies over time, first in the form of SSAPs and then later on in Financial Reporting Standards (FRS). The UK accounting regulation has been influenced by its membership of the EU (formerly the EEC), the US and the development and increasing importance of IFRS. The EU membership led to a change from compliance where UK GAAP had convergence with the EU directives. The British entry came after the detailed requirements of the Fourth Directive were completed but managed to add the true and fair override option to the Directive (Napier 1995). Later on a number of accounting standards were issued many times triggered by the issuance of standards issued in the US and further on by the International Accounting Standards Board (IASB).<sup>2</sup>

From an investor prospective, accounting information is used for two purposes, firstly, the use of financial reporting to value the company and secondly, the use of financial reporting to assess the management's stewardship of the company (Penman 2007; Ardern and Aiken 2005). The former obviously relates to the valuation of net assets and under this view the focus lies on the balance sheet as the main statement with useful information and a focus on current values. The latter refers to the view that the income statement provides an assessment of the management's stewardship of the company. That is, it conveys information on the management's

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<sup>2</sup> The former standards setting organization was the International Accounting Standards Committee (IASC).

ability to arbitrage input and output markets (Penman 2007). This view implies the use of historical cost accounting. The concept of stewardship goes a long way back in the history of accounting and can be traced back to the manorial accounts era when the bailiffs of the manors accounted to the lords on a yearly basis (Napier 1995). In more recent times, Paton and Littleton (1940) discussed revenue recognition and cost attached as a use of historical cost to assess the management's efforts for the period. Historical cost and the stewardship view was basically prevailing in most countries until the 1970s. At present both the US Financial Accounting Standards Board (FASB) and IASB are rapidly moving towards a fair value accounting approach to financial assets and liabilities, and to some extent other assets and liabilities (Ball 2006). This is a development that also did affect the UK but not to the same extent due to the British reluctance to issue standards with too much detailed requirements. As mentioned above, the development of the standards on deferred tax may serve as a good example of this phenomenon. The concept of deferred taxation (or an equivalent) is brought up for the first time in UK accounting in the 1967 Companies Act where the legislation calls for appropriations to avoid unnecessary fluctuations in taxation charges (Hope and Briggs 1982). The method of choice for computation suggested in the 1967 Companies Act was the liability method. In the end of the 1960s, the Accounting Standards Committee's (ASC) issued its first exposure draft on deferred tax and in this they suggested the deferral method for deferred tax computations (the method used in the US at the time). The Exposure Draft 11 (ED) was severely criticized for not providing an option to use either the deferral or the liability method (Hope and Briggs 1982). Consequently, SSAP 11 allowed a choice between the two computation methods. In 1977, ASC issued ED 19, in which they suggested the liability method to be used for computation of deferred taxes. However,

once again, the resulting standards, SSAP 15 is silent on which method of computation to use (Hope and Briggs 1982). Finally, in December 2000, the Accounting Standards Board (ASB) issued FRS 19 requiring the use of the liability method. However, in spite of the fact that UK GAAP now requires something very similar to US GAAP standards and IFRSs, FRS 19 prescribes recognition of deferred tax based on obligations arising as opposed to International Accounting Standard (IAS) 12, which prescribes recognition based on temporary differences. Hence, under FRS 19, the UK is still maintaining an income statement (stewardship) approach (Alexander and Britton2004).

Table 1 below outlines the major differences in measurements between UK GAAP and IFRS. There are five major areas of measurement where UK GAAP and IFRS differ. As shown in the Table below, UK GAAP is slightly more inclined to focus more on the income statement as opposed to the balance sheet compared to IFRS. We interpret this as a tendency to focus more on investors' need of information on the management's stewardship and slightly less on the valuation issue.

<Table 1 about here>

### **3 Previous Capital Market Based Research**

Previous capital market based research with respect to IFRS is mainly based on data where firms voluntary have opted to adopt IFRS (Barth et al. 2005b; Bartov et al. 2005; Hung and Subramanyam 2005; Tendeloo and Vanstraelen 2005; Daske 2006; Goncharov and Zimmerman; Leuz and Verrecchia 2000). The majority of these studies use data of financial reporting of German companies since Germany was one of the pioneers with respect to allowing the use of IFRS, and therefore, there is a lot of German data available. These studies use a variety of methods to investigate the effects of the adoption of IFRS. Bartov et al. (2005) and Hung and Subramanyam

(2005) investigate the value relevance of financial reporting of German companies in the late 1990s and the early 2000s. Bartov et al. find that earnings reported under US GAAP and IAS is more value relevant compared to German GAAP; however, only after firm loss observations are removed. Hung and Subramanyam (2005) find that investors' rely more on book value of shareholders' equity compared to earnings under IFRS and that earnings is of less importance overall. The inconclusive results may be driven by that Hung and Subramanyam (2005) are using a sample including firm loss observations while Bartov et al. (2005) removed them from the sample. At any rate, it seems that firm loss observations have an impact on which component of the reported accounting information the investors' rely on.

Tendeloo and Vanstraelen (2005) and Goncharov and Zimmerman (2006), also using a German sample, examine the prevalence of earnings management before and after the adoption of IFRS. Both studies find no change in the earnings management behaviour. However, it should be noted that the data used in these studies range from 1996 to 2002, a time period where a lot of work to improve comparability and reduce the number of accounting treatments allowed for similar transactions was ongoing but might not really have taken effect.

Leuz and Verrecchia (2000) use German data from 1998 to examine the effect of IFRS or US GAAP adoptions on the information asymmetry using the effect on the bid-asked spread, the trading volume, and the volatility of returns as proxies. They find that firms adopting an international GAAP such as IFRS or US GAAP decrease the bid-asked spread and increase the trading volume, which is interpreted as a decrease in the market information asymmetry. Daske (2006) follows up on this study by investigating the comparing the applied cost of capital for German companies adopting IFRS and those who did not during a time period from 1993 to 2002.

Interestingly enough, he finds that the implied cost of capital actually increases for the IFRS adopters. Daske (2006) discusses two reasons for the unexpected results, firstly, the measure implied cost of capital may be flawed, or secondly, the number of accounting treatments allowed, at least under IFRS, during this time period may have introduced a temporary increased diversity in financial reporting in Germany. Like in the case of some of the previous studies discussed, we interpret Daske's (2006) results as an indication that it is important to control for which period in time the data is collected.

Barth et al. (2005) used a mix of older and later data when examining the effects IFRS adoption on accounting quality for firms in 23 countries from 1994 to 2003. They use a battery of both market-based and accounting-based tests to capture the effects of the adoption of IFRS. They find that adopters of IFRS exhibit less earnings management, more timely loss recognition, and an increase in the value relevance of financial reporting.

The mixed results of the above studies seem to suggest a sensitive to a number of factors. Firstly, firm profitability seems to affect investors' behaviour with respect to relying on different components of the reported accounting information. Secondly, most of the early studies were conducted using German data, it could be that country-specific effects drives the results of these studies and make them less comparable to studies where data from other countries is included in the sample. Thirdly, the standards change considerably during the Comparability Project during the 1990s and early 2000s, which might make it less possible to compare over a long time window. Finally the fact that these companies has voluntarily opted to adopt IFRS may also affect the way they implement these standards.

Using German data, Christensen et al. (2007) investigate the difference in the quality of reported accounting information between firms that do not resist adoption (i.e. voluntary adopters) and resisters (firms who adopt when it becomes mandatory in 2005). They find that voluntary adopters exhibit less earnings management and more timely loss recognition subsequent to the adoption of IFRS. However, as predicted they find no such change in the quality of reported accounting information among the resisters. In addition, they also found that the resisters are more likely to, have a close relationship to banks, be less dependent on equity market financing, and exhibit a more concentrated ownership structure.

There are some studies on the effects of the mandatory adoption of IFRS in the EU that include data from UK companies. Platikanova and Nobes (2006) investigate the effect of the IFRS adoption in a market liquidity study similar to Leuz and Verrecchia's (2000) using a sample from 15 EU countries between 2003 and 2005. They find that the informativeness of financial reporting increased overall after the adoption of IFRS. Horton and Serafeim (2006), on the other hand, focus on UK firms only. They investigate the difference between UK GAAP and IFRS using the required reconciliation between the two at the time of the adoption using an event study. They find that the market reaction to negative reconciliation adjustments of earnings produces a negative abnormal return and positive trading activity. Positive earnings adjustments are value relevant before disclosure while negative are relevant only after disclosure. They interpret this as the management delays bad news but not good news until adoption of IFRS. Moreover, they find that the adjustments related to impairment of goodwill, share-based payments, employee benefits, financial instrument, and deferred taxes are incrementally value relevant.

In summary, previous research is mainly based on data using non-UK data and observations related to voluntary adoption. In addition, the studies tend to be based on a variant of IFRS that is not comparable to the set of standards in place at present. Our study will contribute to the literature by using UK data from the years 2003-2006, which will reduce that the risk of self-selection bias and the avoiding the problem of major changes in IFRS over time. Furthermore, our study is based on UK companies, that is, companies operating in an equity-oriented market as opposed to a country like Germany, which is known for a creditor-oriented capital market.

#### 4 Research Design

We test the ability of financial reporting to predict equity value using Ohlson (1995, 1999) and Feltham and Ohlson (1995, 1996). As outlined below, the linear model is based on three equations (1a-1c) which are forecasting equations implying the linear information dynamics in the valuation equation (2).

$$NI_{it}^a = \alpha_{10} + \alpha_{11}NI_{it-1}^a + \alpha_{12}BV_{it-1} + \alpha_{14}Other_{it} + \varepsilon_{it} \quad (1a)$$

$$BV_{it} = \alpha_{20} + \alpha_{21}BV_{it-1} + \varepsilon_{2it} \quad (1b)$$

$$Other_{it} = \alpha_{30} + \alpha_{31}Other_{it-1} + \varepsilon_{3it} \quad (1c)$$

$$MVE_{it} = \beta_0 + \beta_1NI_{it}^a + \beta_2BV_{it} + \beta_3Other_{it} + \mu_{it} \quad (2)$$

$MVE_{it}$  is the market value of equity at time “t,”  $NI^a$  is abnormal earnings at time “t.” The abnormal earnings is defined as earnings minus the normal return on the book value of shareholders’ equity,  $BV$ . Finally, other information is computed by using the fitted value of  $MVE_{t-1}$  in an estimation excluding other information. We then subtract  $\overline{MVE}_{it}$  from  $MVE_{t-1}$ . We predict that after the adoption of IFRS, investors will tend to rely more on the book value of shareholders’ equity (the

valuation approach) and less on earnings information (the stewardship approach). However, we do not predict any change in reported accounting information overall ability to predict future equity values. Specifically we predict the following:

$$\beta_1^{IFRS} < \beta_1^{UKGAAP}$$

And

$$\beta_2^{IFRS} > \beta_2^{UKGAAP}$$

We use stacked regressions to statistically assess the difference in magnitude of the coefficients under UK GAAPs and IFRS. We also evaluate the difference in the explanatory power of the estimation under UK GAAP and IFRS using Cramer's (1987) test for variance in the  $R^2$ .

## **5 The Sample Selection Process and Descriptive Statistics**

We extracted data for the period from 2003 up to 2006 from Worldscope, Datastream. We selected all British companies listed on the London Stock Exchange for which we had information on the accounting standards applied at this time. We use net income before extraordinary items and when calculating abnormal earnings, we use the monthly average of yield of British Government Securities, 10 year, nominal zero coupon at the month of  $BV_{it-1}$ .

**<Table 2 about here>**

As outlined in Table 3, there seems that there is no significant difference in magnitude between the UK GAAP sample and the IFRS sample. Only other information shows some difference, across the two sample groups on the 10% level

(p-value 0.07).<sup>3</sup> We interpret this as the groups being comparable across accounting policies used.

**<Table 3 about here>**

## **6 Results**

Table 4, Panel A presents the result of the regression of the UK GAAP sample. Both  $\beta_1$  and  $\beta_2$  are positive and significant, which is consistent with prior research (Barth et al. 2005a; Barth et al. 1999; Dechow et al. 1999). In addition the coefficient of the variable representing other information is also positive and significant. As shown in Panel B, the regression of the IFRS sample gives the same result, that is, all coefficients are positive and significant. We hypothesized that investors would switch to a greater reliance on the book value of shareholders' equity and less reliance on earnings information after the switch to IFRS. We use the magnitude of the coefficients to interpret the shift in investors' focus on different components of accounting information. Using stacked regressions we predict and find that the reliance on reported abnormal earnings is significantly less after the switch to IFRS. Likewise, we also predict and find that the reliance on the book value shareholders' is significantly greater after the adoption of IFRS.

**<Table 4 about here>**

## **7 Summary and Concluding Remarks**

In the literature, two approaches which investors can exercise when using accounting information are commonly discussed, either to the use of financial reporting to value the company or the use of financial reporting to assess the management's stewardship of the company (Penman 2007; Ardern and Aiken 2005).

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<sup>3</sup> We have winsorized all continuous variables on the 1% level.

Despite the fact that US GAAP, IFRS, and UK GAAP are all market oriented sets of accounting standards, both FASB and IASB are more inclined to require fair value accounting with regards to assets and liabilities compared to UK GAAP. As opposed to US GAAP and IFRS, UK GAAP tend to a greater extent to encourage the stewardship approach. We examine whether investors' shift their focus from earnings to book value of shareholders' equity after the adoption of IFRS in the United Kingdom. As predicted we find that indeed investors seem to rely more on the book value of shareholders' equity and less on earnings information after the adoption of IFRS. We predicted and found no change in the overall increase accounting information's ability to predict future equity values. However, the results must be interpreted with caution; the results could be driven by a number of alternative explanations that must be explored. We have not tested the effect of loss firm observations. Our findings might be driven by economical conditions across time affecting firms' profitability. In addition, we are mixing "voluntary adopters" and "resisters."

The implications of our study are that we may be observing a shift away from the stewardship approach towards a valuation approach in the UK. A development that might be detrimental in cases where the firm is creating a value using the net assets they hold as opposed to when assets value fluctuate with market prices. In addition, problems will most likely occur in cases when actual market prices are impossible to observe (Penman 2007).

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*Table 1: Main Differences in Measurement approaches Between UK GAAP and IFRS*

<b>Accounting Issue</b>	<b>UK GAAP</b>	<b>IFRS</b>
Intangible assets with indefinite lives	Can be amortized (Focus on the income statement)	Must be impairment tested annually (Focus on the balance sheet)
Development costs meeting certain criteria	Can be capitalized (Focus on the income statement)	Must be capitalized (Focus on the balance sheet)
Investment property	Must be fair valued, with gains and losses going to the statement of total recognized gains and losses (STRGL) (Focus on the balance sheet)	Can be fair valued, if so, gains and losses are recognized in the income statement (Focus on the income statement)
Actuarial gains and losses	Taken immediately to the STRGL (Focus on the balance sheet)	Can be taken gradually to income (Focus on the income statement)
Deferred tax	Based on timing differences, can be discounted (Focus on the income statement)	Based on temporary differences, must not be discounted (Focus on the balance sheet)

*Source: Nobes and Parker 'Comparative International Accounting 9<sup>th</sup> edition page 310 (slightly amended).*

Table 2: The Sample Selection Process.

	<b>UK GAAP</b>		<b>IFRS</b>	
	<b>No.</b>	<b>No.</b>	<b>No.</b>	<b>No. observations</b>
	<b>companies</b>	<b>observations</b>	<b>companies</b>	
Total number of observations extracted from Datastream	2,100	5,823	1,115	1,954
Excluded observations due to missing data	<u>-262</u>	<u>-3418</u>	<u>-223</u>	<u>-1,053</u>
Total sample	1,838	2,405	892	901

Table 3: Descriptive Statistics.

<b>Panel A: UK GAAP sample (N=2,405)</b>					
	Mean	Std. Dev	25% Percentile	50% Percentile	75% Percentile
Abnormal earnings <sup>1</sup>	20,975.250	104,195.900	-1,245.820	113.784	3,910.680
Book value of equity <sup>2</sup>	218,008.400	736,540.600	3,553.000	14,664.000	66,064.000
Other information <sup>3</sup>	18,109.410	1,297,093	-78,239.070	-57,513.070	-11,833.92
<b>Panel B: IFRS sample (N=901)</b>					
	Mean	Std. Dev	25% Percentile	50% Percentile	75% Percentile
Abnormal earnings	20,844.940	98,165.590	-1,212.013	190.839	4,827.630
Book value of equity	226,237.500	730,243.900	3,329.000	13,637.000	74,705.000
Other information	-38,391.780	1,052,219.000	-83,817.870	-60,896.680*	-14,604.340

<sup>1</sup> Abnormal earnings is defined as net income before extraordinary and non-continuous items minus the normal return on the book value of shareholders' equity. The normal return on shareholders' equity is calculated by multiplying shareholders' equity at time t-1 by the monthly average of yield of British Government Securities, 10 year, nominal zero coupon at the month.

<sup>2</sup> Book value of equity is defined as book value of shareholders' equity at time t.

<sup>3</sup> Other information is computed by using the fitted value of the market capitalization value at time t-1 in an estimation excluding other information. We obtain the variable other by subtracting the fitted value of the market capitalization value at time t-1 from the market capitalization value at time t-1.

Asterisks indicate that the means (medians) of the UK GAAP observations are significantly different from the IFRS observations using a two-tailed t-test (Mann-Whitney-Wilcoxon test): \* p < 0.1, \*\* p < 0.05, and \*\*\* p < 0.01.

Table 4: Regression of Market Value on Accounting Information

$MVE_{it} = \beta_0 + \beta_1 NI_{it}^a + \beta_2 BV_{it} + \beta_3 Other_{it} + \mu_{it}$					
<b>Panel A: UK GAAP sample (N=2,405)</b>					
	Coefficient	Std. Error	t-statistics	p-value (two-tailed)	R <sup>2</sup>
Intercept	67,144.950	3,541.525	18.960	0.000	0.97
Abnormal earnings <sup>1</sup>	12.759	0.047	272.320	0.000	
Book value of equity <sup>2</sup>	1.564	0.007	235.940	0.000	
Other information <sup>3</sup>	1.000	0.003	381.960	0.000	
<b>Panel B: IFRS sample (N=901)</b>					
	Coefficient	Std. Error	t-statistics	p-value (two-tailed)	R <sup>2</sup>
Intercept	57,437.690	6,794.380	8.450	0.000	0.99
Abnormal earnings <sup>1</sup>	12.304	0.016	102.67	0.000	
Book value of equity <sup>2</sup>	1.637	0.016	159.31	0.000	
Other information <sup>3</sup>	1.004	0.006	159.31	0.000	
<b>Panel C: Hypothesis tests</b>					
	p-value (one-tailed)	p-value Vuong's test			
$\beta_1^{IFRS} < \beta_1^{UKGAAP}$	0.000				
$\beta_2^{IFRS} > \beta_2^{UKGAAP}$	0.000				
UK GAAP R <sup>2</sup>	0.97				
IFRS R <sup>2</sup>	0.99				
Diff	-0.02	0.99			

<sup>1</sup> Abnormal earnings is defined as net income before extraordinary and non-continuous items minus the normal return on the book value of shareholders' equity. The normal return on shareholders' equity is calculated by multiplying shareholders' equity at time t-1 by the monthly average of yield of British Government Securities, 10 year, nominal zero coupon at the month.

<sup>2</sup> Book value of equity is defined as book value of shareholders' equity at time t.

<sup>3</sup> Other information is computed by using the fitted value of the market capitalization value at time t-1 in an estimation excluding other information. We obtain the variable other by subtracting the fitted value of the market capitalization value at time t-1 from the market capitalization value at time t-1.