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First-Time Adoption of IFRS, Managerial Incentives and Stock Market Assessment: Some French Evidence

Première application des IFRS, choix stratégiques et valorisation boursière : le cas de la France

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Abstract

This paper investigates how reporting incentives and constraints influence managers' decisions to elect for optional exemptions allowed at first-time adoption of IFRS as well as French stock market assessment of such choices. Relying on a system of equations that controls for endogeneity between IFRS optional exemptions and French stock market assessment, our results show that accounting choices are determined by a firm's contracting costs and benefits. Furthermore, our results generally suggest that French stock markets participants are able to assess the impact of these optional exemptions on financial statements. Concerning the reconciliation of equity presented as part of the transition from French GAAP to IFRS, it appears that first-time IFRS equity adjustment is slightly more valued by stock markets than stockholders' equity established based on French GAAP.

Key words: Accounting choices, IFRS No. 1 optional exemptions

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Résumé

Cette étude se penche sur les choix comptables exercés par les dirigeants d'entreprise lors de la première application des IFRS. Nous nous intéressons aux déterminants des choix d'exemption aux IFRS de même qu'à la valorisation boursière des ces choix. À partir d'équations simultanées visant à tenir compte de l'endogénéité entre l'option d'exemption aux IFRS et la valorisation boursière, nos résultats montrent que les choix comptables sont généralement tributaires de contraintes contractuelles. En outre, nos résultats montrent que le marché boursier français est en mesure d'interpréter l'impact des choix d'exemption aux IFRS sur les états financiers. Il semble également que l'ajustement initial des fonds propres suite à l'adoption des IFRS soit plus valorisé par les marchés boursiers que les fonds propres initialement établis selon le référentiel comptable français.

Mots-clés : Choix comptables, exemption IFRS No. 1.

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1.   Introduction

Accounting choices surrounding IFRS adoption, as any accounting choice, are not

exempt from both contracting and market incentives. In this context, it is worthwhile to

investigate whether stock markets are in a position to assess the incidence of these

choices on financial statements. More specifically, if market participants perceive net

benefits associated with convergence of accounting standards, we would observe

differences in stock market valuation between local accounting standards, mandated IFRS

and voluntary IFRS choices. The value relevance of earnings and book value of equity

are generally higher in countries with a dominant market-oriented financing system and

an Anglo-Saxon accounting orientation (Ali and Hwang, 2000). However, it does appear

that providing value-relevant information is not the primary driver of accounting and

disclosure in code law countries such as France (Bushman and Smith, 2003). We think

that the French context offers a unique opportunity to investigate IFRS adoption.

A survey carried out over 550 firms from 12 European countries in April 2005 (Mazars,

2005), shows that only a quarter of French companies, compared to almost 50% across

Europe, believe that IFRS will improve quality and transparency of accounts, and 37%

versus 63% believe it will facilitate comparisons between countries. France is without

contest the country with the most sceptical attitude towards the new standards. This

explains, in part, the weak support by French companies for the implementation of IFRS.

French companies express some of the greatest concern in Europe with regard to the increased volatility caused by the greater conformity of IFRS to economic substance (60% compared to 45% across Europe). In most optional exemptions allowed by IFRS No. 1, no specific treatment is provided by French GAAP (e.g., Employee benefits, Share-based payments, Financial instruments). Consequently, we think France offers an interesting context to investigate factors affecting accounting choices surrounding first-time adoption of IFRS and to assess how stock market participants integrate these choices.

Therefore, our purpose in this article is twofold. First, to assess, in the French context, managerial incentives to elect for optional exemptions allowed at first-time adoption of IFRS, and second, to analyze how stock markets impound these choices.

Relying on a system of equations that controls for endogeneity between IFRS optional exemptions and French stock market assessment, we show that the decision to elect for an optional exemption is influenced by a firm's contracting costs and benefits. Furthermore, our results generally show that French stock markets are able to assess the impact of these optional exemptions on financial statements. Concerning the reconciliation of equity presented as part of the transition from French GAAP to IFRS, it appears that first-time IFRS equity adjustment is slightly more valued by stock markets than stockholders' equity established based on French GAAP.

The remainder of the paper is organized as follows. Section 2 contains a description of the context in which French firms are evolving. The study's theoretical background and method are developed in section 3 while results are discussed in section 4. Finally, section 5 concludes, and provides some implications of this study.

2.   Context

In March 2002, the European Parliament passed a resolution requiring all firms listed on European exchanges to apply IFRS when preparing their consolidated financial statements. This requirement applied to fiscal years beginning on or after January 1, 2005, and affected approximately 7,000 firms listed on European stock exchanges (around 1,000 in France) starting in 2005. The adoption of IFRS in European countries reflects the goal of achieving capital market integration in Europe and between Europe and the rest of the world. In this paper, we focus on first-time adopters of IFRS.

A first-time adopter is an entity that, for the first time, makes an explicit and unreserved statement that its general-purpose financial statements comply with IFRS.
The objective of IFRS No. 1 is to ensure that a firm's *first IFRS financial statements* contain high quality information that: (a) is transparent for users and comparable over all periods presented; (b) provides a suitable starting point for accounting under *International Financial Reporting Standards (IFRS)*; and (c) can be generated at a cost that does not exceed the benefits to users.

An entity must prepare an *opening IFRS balance sheet* at the *date of transition to IFRS*. The IFRS grants limited exemptions from these requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The IFRS No. 1 also prohibits retrospective application of IFRS in some areas; particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known. The IFRS requires disclosures that explain how the transition from previous GAAP to IFRS affected an entity's reported financial position, financial performance and cash flows.

IFRS No. 1 allows companies to choose a number of options on first time adoption. In this paper, we will concentrate on five optional exemptions**:**

- Revaluation as deemed cost (IAS No. 16 and IAS No. 40);

- Employee benefits (IAS No. 19);

- Share-based payment (IFRS No. 2);

- Financial Instruments (IAS No. 39); and

- Cumulative translation differences (IAS No. 21).

An additional option allowed by IFRS No. 1 relates to IFRS No. 3 *Business combinations*. IFRS No. 1 gives exemptions to first-time adopters of IFRS from applying IFRS No. 3 retrospectively to past business combinations that occurred before the date of transition to IFRS. A large majority of our sample firms, i.e. 99 firms out of 107, opted

not to apply retrospectively IFRS No. 3. Therefore, we exclude that exemption from our study.

Revaluation as deemed cost (IAS No. 16 and IAS No. 40)

Under IFRS No. 1, property, plant and equipment, intangible assets, and investment properties carried at cost may be measured at their fair value at the opening IFRS balance sheet date. Fair value becomes the deemed cost under IFRS. Asset revaluation is allowed under French GAAP but revaluation adjustment does not affect earnings. This exemption allows, also the revaluation of intangible assets as defined by IAS No. 38. Due to the complexity to intangible valuation, the IASB does not encourage revaluation for intangible assets. Consequently, we noticed that no firm has applied the exemption for intangible assets. Then, we focus only on property plant and equipment and on investment property.

Employee benefits (IAS No. 19)

An entity that elects to recognize actuarial gains and losses resulting from the measurement of defined benefit plans after the date of transition to IFRS can apply the corridor approach permitted by IAS No. 19. However, it may still decide not to apply the corridor approach retrospectively and to recognize all cumulative actuarial gains and losses from defined benefits directly in equity at the date of transition to IFRS.

Under French GAAP, companies may choose either to recognise or not recognise obligations under defined benefit schemes and other similar post-employment benefits. Furthermore, if such obligations are recognised, a firm may choose whether to recognise them in full or on a partial basis. Therefore, we can expect the application of IAS No. 19 to have a significant impact on shareholders' equity and current and future earnings. This should motivate managers to opt for the optional exemption that allows the recognition of all cumulative actuarial gains and losses directly in equity.

Share-based payment (IFRS No. 2)

Under IFRS 1, equity instruments from share-based options granted on or before November 7, 2002 and those granted after November 7, 2002 and vested before January 1, 2005 do not have to be recognized under IFRS 2 by a first-time adopter. A first-time adopter may choose to apply IFRS No. 2 to other instruments if the firms have previously disclosed publicly the fair value of the instruments at the measurement date. Since there is no accounting requirement for stock-based payments under French GAAP, firms that elect to apply IFRS No. 2 to equity instruments granted after November 2002 that vested before the date of the transition (or January 1st, 2005) are likely to exhibit a lower stock option compensation in 2005 compared with firms that do not opt for that optional exemption.

Financial Instruments (IAS No. 39)

A firm may elect to adopt IAS No. 39 before January 1, 2005 with no restatement of comparative information. Any entity is allowed to make an available-for-sale designation at the date of the transition and to designate any financial asset or financial liability as at fair value through profit and loss. Under French GAAP, financial assets are valued at the lower of cost or market.

Cumulative translation differences (IAS No. 21)

Under IAS No. 21, differences from the translation of financial statements prepared in a currency other than the presentation currency of the parent entity must be recognized as a separate component of shareholders' equity. In line with the principle of retrospective application of IFRS, these differences would have to be determined retrospectively. According to the exemption in IFRS No. 1, cumulative translation differences may be deemed zero at the date of transition. In the case of subsequent disposal of the entity concerned, only translation differences that arose after the date of transition to IFRS are recognized in profit or loss.

Consistent with IAS No. 21, under French GAAP, when translating financial statements of consolidated foreign entities, either the temporal or the closing rate method is required, depending on the way the foreign entity is financed or operates in relation to the reporting entity. Gains and losses are recognised in shareholders' equity under cumulative

translation differences. Therefore, we can expect the cumulative translation adjustment to be substantial for many firms. This should motivate firms to opt for the exemption, i.e. cumulative translation differences are deemed zero at the date of transition.

3.   Theoretical background and method

3.1   Model 1 - Treatment effect

This study is based on positive accounting theory and prior research on the determinants of voluntary disclosure. In France, Cormier and Martinez (2006), in an IPO's context, find some evidence suggesting that the voluntary compliance to international accounting standards increases the use of accounting discretion to manage earnings.

Researchers on mandatory accounting changes examine the determinants of firms' accounting choices when a choice exists between alternative implementation methods. Gujarathi and Hoskin (1992) investigate managers' preferences concerning the adoption of SFAS 96 on deferred Income taxes. Balsam, Haw and Lilien (1995) examine a broader set of mandatory accounting changes. Both studies find that firms with a positive cumulative effect of the change in accounting policy tend to choose the cumulative effect method. Conversely, firms with a negative cumulative effect prefer the retroactive method. Ramesh and Revsine (2000), D'Souza (1998), and D'Souza, Jacob and Ramesh (2000) examine the determinants of firm preferences for immediate recognition versus amortization over a 20-year period of net accumulated postretirement benefit obligation

upon the adoption of SFAS 109. They show that firms select the method that reduces

regulatory and employee benefit costs. In our paper, we investigate factors affecting the

reporting of first-time IFRS adoption by the retroactive method, i.e., optional exemption

permitted in IFRS No. 1. To the best of our knowledge, this study is the first to formally

investigate the determinants and consequences of IFRS No. 1 optional exemptions,

relying on simultaneous equations.

Fields, Lys and Vincent (2001) argue that a significant shortcoming of numerous

empirical disclosure studies is the failure to address the endogenous nature of the

disclosure quality decision. This study examines whether the decision to opt for

exemptions in the application of IFRS is associated with stock market value. Endogeneity

will be of concern if we fail to take into consideration the factors that explain the

exemption decision. In this empirical definition of endogeneity, variables are inherently

neither exogenous nor endogenous, and their nature is conditional on the way the

structural model is written (Nikolaev and Van Lent, 2005). Thus, we must formally

control for endogeneity by relying on simultaneous equations.

In model 1, we rely on treatment effect two-step estimates. The treatment effects model

considers the effect of an endogenously chosen binary treatment (i.e. optional exemption)

on another endogenous continuous variable, conditional on two sets of independent

variables. Then, we compare results with ordinary least square estimation regressions.

The model is as follows:

Optional exemption decision$_{it}$ =

f(ß$_0$ + Stock options + ß$_1$ Firm's size + ß$_2$ Leverage + ß$_3$ Analyst following + ß$_4$

Concentrated ownership + ß$_5$ Institutional ownership + ß$_6$ Return on assets + ß$_7$ Foreign

listing + ß$_8$- ß$_{17}$ Industry)$_{it}$ (1)

Stock price$_{it}$ =

f(ß$_0$ + Equity per share + ß$_1$ Equity per share*Optional exemption decision + ß$_2$ Optional

exemption decision + ß$_3$ Operating cash flow per share + ß$_4$ Accruals per share)$_{it}$ (2)

The stock price model is coherent with prior empirical work (e.g. Ohlson, 1995; Amir and Lev, 1996; Amir, 1993).

Consistent with prior findings, Equity per share, Operating cash flow per share, and Accruals per share are expected to have positive signs. The components of earnings per share valuation multiple can be interpreted as a proxy for a firm's cost of equity capital (Kothari and Zimmerman, 1995). We distinguish between Cash flow from operations and total Accruals since they are likely to be valued differently (Penman, 2001; Barth, Beaver, Hand and Landsman, 2005). Equity per share*Optional exemption decision captures the moderating impact optional exemption for first-time adopters on equity valuation multiple. We also include Optional exemption decision as main effect because the regression includes an interaction term. Our study focus on the impact of optional exemptions on shareholders' equity essentially because most optional exemptions affect directly equity, and because IFRS equity adjustments are likely to influence several key

accounting ratios (Return on assets, leverage).

3.1.1 Model 1: Variables definition

Determinants of optional exemption decision

Optional exemption decision. A binary variable is used, 1 if the firm opts for the optional exemption at first-time adoption of IFRS, 0 if not.

Stock options. The importance of contracting costs may lead to incomplete contracts and agency conflicts. The more agency conflicts between managers and shareholders are important, the more managers with stock-based compensation will manage accounting numbers to maximize the value of their stock options. According to Azofra, Castrillo and Delgado (2000), the more growth opportunities firms have, the more managers will exercise accounting discretion on earnings figures. We expect accounting choices to be opportunistically affected by the presence of CEO stock options. The variable *Stock options* is a dichotomous variable that takes the value of 1 if the firm offers stock options to its employees, 0 otherwise.

Leverage. Debt financing generates incentives for the exercise of accounting discretion. Lenders rely extensively on financial statements for the evaluation of a firm's financial standing and credit rating. Therefore, managers of firms that need the continuous support of their lenders have incentives to opt for income-increasing accruals that enhance their

firm's level of profitability and leverage ratios (DeFond and Jiambalvo, 1994). Highly

levered firms are likely to be less inclined to favour accounting policies that reduce

earnings or increase debt ratios. Leverage is the ratio of long-term financial debt over

total assets.

Analyst following. A firm's analyst following is often used as a proxy for the extent of a

firm's communication with financial analysts (Leuz, 2003). Moreover, Lang and

Lundholm (1996) and Healy, Hutton and Palepu (1999) find a positive relation between

analyst following and the quality of a firm's disclosure. In the present context, we can

argue that the complete adoption of IFRS without exemptions will improve financial

reporting. However, highly followed are likely to manage current or future earnings using

optional exemptions. The variable *Analyst following* corresponds to the number of

analysts that follow a firm according to IBES database.

Concentrated ownership. Positive accounting theory literature suggests that management-

controlled firms (diffuse ownership) opt for income increasing accruals (Dhaliwal,

Salamon and Smith, 1982; Warfield, Wild and Wild, 1995). The maximization of the

present value of bonus plan payments is a likely outcome of such behaviour (Holthausen,

Larcker and Sloan, 1995). In addition, Dempsey, Hunt and Schroeder (1993) find more

income decreasing accruals (extraordinary losses) for entrepreneur-controlled firms than

for firms with diffuse ownership. It seems that the higher the percentage of stock held by

an entrepreneur, the less the incentive to increase earnings through accruals management.

In that case, managers prefer to focus on wealth maximization through share price

appreciation (Dechow and Sloan, 1991; Holthausen *et al.,* 1995). Azofra *et al.* (2000) show that the absolute value of discretionary accruals declines with ownership concentration, this result being consistent with large shareholders playing an active role in corporate governance. The variable *Concentrated ownership* takes the value of 1 if there is a control block of ownership of at least 10% of voting shares, 0 otherwise.

Institutional ownership. In the specific context of France, institutional ownership is also likely to affect accounting discretion because institutional blocks are most often held by financial institutions involved intensively in the day-to-day operations. The variable *Institutional ownership* takes the value of 1 if there is a control block of ownership of at least 10% of voting shares, 0 otherwise.

Return on assets. Managers must maximize a firm's financial performance. Therefore, we can expect that the lower the profitability, the higher the probability managers elect to choose accounting methods that increase that profitability. In the French context, Chalayer and Dumontier (1996) find accruals management when a firm current earnings deviates from the mean of the industry membership, i.e. either highly positive or highly negative target deviation.

Foreign listing. A French firm's listing on a foreign stock exchange implies that its reported earnings are followed by foreign investors or analysts, thus increasing the level of monitoring imposed on managers in their accounting decisions. Moreover, by being listed on foreign stock exchange, the firm increases its reliance on international investors

for additional capital or for setting its stock price. We can expect that firms cross-listed to non-European stock exchanges will be inclined to adopt complete IFRS without exemptions since doing this will produce more comparable financial statements with US-GAAP. However, taking the option to anticipate IAS No. 39 will also make financial statements more comparable with US-GAAP. The variable *Foreign listing* is coded 1 if a firm is cross-listed in a non-European stock exchange, 0 otherwise.

Firm size. In the context of positive accounting theory, firm size is posited to proxy for political costs faced by a firm (Watts and Zimmerman, 1978). A consistent result across many positive accounting studies is the influence of size in the determination of a firm's accounting policies (Watts and Zimmerman, 1990). *Firm size* is measured as the natural log of total assets.

Determinants of Stock price

Armstrong, Barth, Jagolinzer and Riedl (2007) examine the European stock market reaction to sixteen key events associated with the adoption of International Financial Reporting Standards (IFRS) in Europe. They find significant positive (negative) market reactions to events that increase (decrease) the likelihood of IFRS adoption, which indicates that European equity investors perceive net benefits to adoption of IFRS. To assess whether this positive reaction to IFRS adoption reflects benefits from convergence of accounting standards or from improvement of information quality, they group firms by the quality of their pre-adoption information environments. They find a significant

positive reaction to IFRS adoption for firms with higher quality pre-adoption information environments. They interpret this result as indicating the market perceives net benefits associated with convergence of accounting standards. They also find a significantly more positive market reaction to IFRS adoption for firms with lower quality pre-adoption information environments. They interpret this result as indicating the market perceives net benefits associated with improved information quality under IFRS, to the extent that the benefits of convergence are similar for the two groups of firms.

There is evidence that accounting amounts based on IAS are of higher quality than those based on a large number of countries' domestic standards, using a variety of quality metrics (Barth, Landsman, and Lang, 2006). Consistent with this, Karamanou and Nishiotis (2005) finds positive abnormal returns for a small set of firms announcing voluntary adoption of IAS between 1989 and1999. Dumontier and Maghraoui (2006) find similar results for a sample of Swiss firms since they show that firms applying IFRS exhibit lower bid-ask spreads than those using Swiss GAAP and that the impact of IFRS on bid-ask spread decreases with firm size. This prior research suggests the market will react favourably to events that move Europe closer to IFRS adoption because it expects higher quality financial reporting information under IFRS than under domestic standards.

Horton and Serafeim (2007) investigate whether there is any market reaction to and value relevance of the information contained in transitional documents required by IFRS No. 1 *First-Time Adoption of International Financial Reporting Standards*. They find statistically significant negative abnormal returns for firms reporting a negative

reconciliation adjustment on UK GAAP earnings to achieve compliance with IFRS. This reaction is also consistent with the trading activity surrounding the event day since they also find significant positive abnormal trading activity on the event day for these firms. In terms of valuation, they find the total earnings reconciliation adjustment to be value relevant. A finer model reveals that adjustments attributed to impairment of goodwill, share based payments, employee benefits, and deferred taxes are incrementally value relevant. It appears that the value relevance of the employee benefit reconciliation is, among other things, determined by the firms' previous disclosure option available under UK GAAP. The results are consistent with IFRS altering investors' beliefs about stock prices.

Revaluation (IAS No. 16 and IAS No. 40)

Since shareholders' equity increases for firms that make the choice to revaluate assets or investment properties upward, we expect a lower equity multiple as expressed by a negative interaction term *Equity per share* Optional exemption decision.* In our sample, all but two firms that revaluate exhibit gains. Therefore, we will drop the two firms that revaluate downward.

IAS No. 19

The optional exemption allows the recognition of all cumulative actuarial gains and losses in equity at the date of transition to IFRS. In our sample, all firms that opted for

that exemption exhibit actuarial losses. Therefore, this exemption decision will reduce shareholders' equity. We than expect a positive interaction term *Equity per share*Optional exemption decision.*

IFRS No. 2

Firms that elect to apply IFRS No. 2 to equity instruments granted after November 2002 that vested before the date of the transition (or January 1st, 2005) are likely to have less vested stock option compensation in 2005. Since the recognition of stock option in the income statement does not affect stockholders' equity (the decrease in reserves being cancelled out by an increase in capital surplus), no interaction term *Equity per share*Optional exemption decision* will be used. However, a binary variable *Optional exemption decision* will serve to capture the potential effect of this accounting choice on stock price. We restrict our analyses to the 98 firms that have stock option plans.

IAS No. 39

At the date of the transition, an entity is allowed to make an available-for-sale designation and to designate any financial asset or financial liability at fair value through profit and loss. We expect a negative and significant interaction term *Equity per share*Optional exemption decision* (IAS No. 39) since if a first-time adopter elect to measure financial assets at fair value, this will reduce equity value multiple. Among the firms that opt for

anticipation of IAS No. 39, five firms exhibit holding losses at the transition date. We will restrict our analyses to 102 firms (107 minus 5).

IAS No. 21

Under IAS No. 21, differences from the translation of financial statements prepared in a currency other than the presentation currency of the parent must be recognized as a separate component of equity. In line with the principle of retrospective application of IFRS, these differences would have to be determined retrospectively. According to the exemption in IFRS No. 1, cumulative translation differences may be deemed zero at the date of transition. This accounting choice affects neither total shareholders' equity nor earnings. However, it does affect retained earnings component. It is possible that stock market participants value differently retained earnings and cumulative translation differences, the risk associated with translation differences being higher. For example, if a cumulative loss is seen as unrealized, while the switch to retained earnings is an indication that the loss is likely to realize, this accounting choice could lead to a reduction on stock price. We will add a binary variable in the model *Optional exemption decision* for firms that exhibit cumulative losses. Analyses will be restricted to 103 observations since four firms exhibit optional cumulative translation gains.

3.2   Model 2 – Valuation of IFRS adjustments

In model 1, we explain the sign of the relation between an accounting choice and stock market valuation. We cannot infer direct impact on stock price since we are using binary

variables to express optional exemptions under IFRS first-time adoption. The aim of our second model is to assess how stock markets impound IFRS equity adjustments for first-time adopters. We will analyse whether optional exemption adjustments are valued differently than other opening IFRS equity adjustments. Therefore, stockholders' equity is divided into three distinct components: Equity less initial IFRS equity adjustment (i.e. equity in French GAAP), initial IFRS equity adjustment net of the impact on equity of the optional exemption, and equity adjustment concerning the optional exemption. In model two, we replace Operating cash flow per share and Accruals per share by Earnings per share, since the coefficients for both variables used in model 1 are quite similar.

The model is the following:

Stock price$_{it}$ =

f(ß$_0$ + ß$_1$ Equity per share less IFRS equity adjustment + ß$_2$ IFRS equity adjustment less Optional exemption adjustment+ ß$_3$ Optional exemption adjustment+ ß$_4$ Earnings per share)$_{it}$ (3)

Model 2 allows us to assess how stock price impounds optional exemptions compared to mandatory application of IFRS. Higher quality accounting data have a higher association with stock prices and stock returns (Barth, Beaver, and Landsman, 2001; Lang, Raedy, and Yetman, 2003; Leuz, Nanda, and Wysocki, 2003; Lang, Raedy, and Wilson, 2005; Barth, Beaver, Hand and Landsman, 2005). More specifically, firms with higher earnings

quality have a higher association between stock prices and stockholders' equity (Barth, Beaver and Landsman, 2001; Barth *et al.,* 2005).

Ashbaugh and Pincus (2001) investigate whether the variation in accounting standards across national boundaries relative to International Accounting Standards has an impact on the ability of financial analysts to forecast non-US firms' earnings accurately, and whether analyst forecast accuracy changes after firms adopt IAS. They document that greater differences in accounting standards relative to IAS are significantly and positively associated with the absolute value of analyst earnings forecast errors and that analyst forecast accuracy improves after firms adopt IAS. Therefore, we can expect the coefficient for mandated IFRS equity adjustment to be higher than the coefficient for French GAAP equity.

For IFRS No. 2, we do not have access to precise numbers concerning of the impact on equity. However, first-time adopter may choose to apply IFRS No. 2 to equity instruments granted after November 2002 that vested before the date of the transition are likely to have less vested stock option compensation in 2005, i.e. *ceteris paribus* to show a higher earnings figure. Therefore, since this optional choice is likely to affect 2005 earnings, we will add an interaction term Earnings per share*Optional exemption decision.

3.3   Sample

The sample is composed of 107 firms for year 2005. First, SBF 120 firms were identified.

Thirteen firms were deleted (3 firms are using US-GAAP, 7 firms merged and 3 were

already preparing their accounts according to IFRS before 2005). We collected

information about the optional exemption retained at the transition date in the annual

reports. Other financial data are collected from Worldscope and IBES databases. Our

sample represents 67% of French stock market capitalisation at the end of 2005.

Concerning IFRS No. 2, 98 out of 107 firms grant stock options to their employees.

Analyses will focus on these 98 firms. For model 2, we only find the information

concerning the optional exemption adjustment for IAS No. 21 *Cumulative translation*

adjustment for 95 firms.

4.   Results

4.1   Descriptive statistics

Eighty-one percent of sample firms first-time adopters elect for optional exemptions

related to IAS No. 21 permitting cumulative translation differences may be deemed zero

at the date of transition. Seventy-nine percent elect to apply IFRS No. 2 to equity

instruments granted after November 2002 that vested before the date of the transition.

Seventy-six percent elect to recognize all cumulative actuarial losses at the date of

transition to IFRS. Forty-eight percent anticipate the adoption of IAS No. 39 while only

22% of sample firms opt for partial asset revaluation under IAS No. 16 and IAS No. 40.

Equity adjustment arising from IFRS adoption represents in average 0.34 €per share.

Equity adjustment from optional exemption represents on average 0.119 €for IAS No.

39, 0.28 €for IAS No. 16-40, -1.126 €for IAS No. 19 and -1.018 €for IAS No. 21.

Eighty-eight percent of firms have a stock-option plan, are highly followed by financial

analysts (25 analysts on average), have low leverage (22% of total assets on average),

have a concentrated ownership (56% of firms have control blocks of more than 10%).

[Insert table 1]

4.2   Determinants of optional exemption decisions

Since we posit that contracting factors affect the IFRS exemption decision and market

valuation simultaneously, we rely to simultaneous equations to control for endogeneity

between these factors. Results presented in table 2A suggest that endogeneity is not an

important issue, except may be for the optional exemption related to IFRS No. 2 (lambda

$p < 0.264$) and to IAS No. 21 (lambda $p < 0.156$). For these two optional exemption

decisions, we cannot, beyond doubt, assume the null hypothesis of no endogeneity.

IAS No. 16 and No. 40

We observe that two factors are positively associated with the decision to revaluate assets or investment properties at the transition date, the presence of stock options plans (0.956; $p < 0.10$) and for a concentrated ownership (0.829; $p < 0.01$). In the presence of stock option plans, in an effort to maximize stock price, managers have incentives to reduce release information that reduces asymmetry between investors and the firm.

IAS No. 19

The presence of stock options (1.152; $p < 0.01$), leverage (3.051; $p < 0.01$) and analyst following (0.637; $p < 0.10$) appear to be the key determinants of the decision to elect to switch cumulative actuarial losses to retained earnings. An explanation for that decision is the desire to avoid the recognition of losses in future earnings. In our sample, all firms that opt for optional exemption have actuarial losses. This behaviour is consistent with Ramesh and Revsine (2000), D'Souza (1998), and D'Souza, *et al*. (2000) who show that firms with a negative cumulative effect prefer the retroactive method.

IFRS No. 2

Firms that elect to apply IFRS No. 2 to equity instruments granted after November 2002 that vested before the date of the transition (or January 1st, 2005) are likely to have less

vested stock option compensation in 2005, i.e. *ceteris paribus* to show a higher earnings figure.

For sample firms with stock option plans (98 firms out of 107), coefficients for leverage (4.276; $p < 0.05$), for analyst following (1.217; $p < 0.05$), and for concentrated ownership (0.72; $p < 0.10$) are positively associated with the transition option while the opposite is true for return on assets (-0.098; $p < 0.05$) and institutional investors (-1.004; $p < 0.01$). This earnings management tool is used for highly levered firms and firms highly followed by analyst, concentrated ownership and firms with lower profitability.

IAS No. 39

We observe that almost all factors associated with the decision to anticipate the recognition of holding gains at the date of the transition to IFRS are significant. This anticipation of the adoption of IAS No. 39 is positively related to the presence of stock options (6.996; $p < 0.01$) and foreign listing (1.544; $p < 0.01$) while negatively related to size (-0.224; $p < 0.01$). An explanation for that negative sign could be that large firms exhibit holding losses and prefer not to anticipate their recognition. This explanation is sound since out of 56 firms that did not anticipate IAS No. 39, at the end of 2004, 23 firms show shareholders' equity higher in French GAAP compared to IFRS while the opposite is observed for only 9 firms. The remaining 24 firms exhibit no difference or a slightly difference. Among these 23 firms, we can cite very large firms such as Air France, Air Liquide, EDF, Thomson, and BIC. Moreover, US cross-listed firms are

constrained to reconcile their financial statements from local GAAP to the US GAAP, and therefore to retreat financial instruments. Hence, firms that are listed on a foreign market can be more inclined to anticipate the adoption of IAS No. 39. This is the case for Publicis or Danone.

IAS No. 21

The decision to transfer cumulative translation differences to retained earnings at the date of transition do not affect current earnings but could impact future comprehensive income (change in stockholders' equity). Our results, based on sample firms that exhibit cumulative losses, show that firm's size (0.188; $p < 0.10$) and profitability as expressed by return on assets (-0.080; $p < 0.05$) are associated with the decision to apply this optional exemption. Less profitable firms would be more inclined to opt for that exemption.

4.3   Stock market valuation of optional exemption decisions (model 1)

Results presented in table 2A for equation 2 show that the coefficients for *Equity per share*, *Cash Flow from operations*, and *Accruals* are significant in all five regressions. We now discuss the results concerning coefficients for optional exemption decisions.

[Insert table 2A]

IAS No. 16 and No. 40

As expected, firms that choose to revaluate assets or investment properties exhibit a lower equity multiple since the interaction term *Equity per share*Optional exemption decision* is negative and significant (-0.624; $p < 0.10$). However, the coefficient is marginally significant. One explanation could be that in most cases, revaluation is partial (or minor).

IAS No. 19

A first-time adopter can recognize all cumulative actuarial losses in shareholders' equity at the date of transition to IFRS. Considering that all sample firms that opted for that exemption exhibit actuarial losses, we would expect a positive and significant interaction term *Equity per share*Optional exemption decision.*

However, this transition choice do not seem to affect market valuation multiple of equity since the coefficient for the interaction term is not significant (0.314; $p < 0.578$). This would suggest that stock market participants have difficulties to interpret the impact of that transition choice. This result is consistent with Barth, Beaver and Landsman (1992) findings that amortization components such as actuarial gains and losses do not have any value for stock markets.

IFRS No. 2

Since the recognition of stock option in the income statement does not affect stockholders' equity (the decrease in retained earnings being cancelled out by an increase in capital surplus), no interaction term *Equity per share*Optional exemption decision* was used. However, the coefficient for the dummy variable *Optional exemption decision* is not significant (-15.361; $p < 0.322$), suggesting that the potential effect of this accounting choice on stock price is inexistent.

IAS No. 39

If a first-time adopter elects to measure financial assets at fair value, this will reduce equity value multiple. We then expect a negative and significant interaction term *Equity per share*Optional exemption decision*. Our results confirm this expectation since the coefficient for the interaction term *Equity per share*Optional exemption decision* (-0.615; $p < 0.10$).

IAS No. 21

According to the exemption in IFRS No. 1, cumulative translation differences may be deemed zero at the date of transition. This accounting choice does not affect total shareholders' equity. However, it does affect retained earnings component. It is possible that stock market participants value differently retained earnings and cumulative

translation differences, the risk associated with translation differences being higher. For example, if a cumulative loss is perceived as unrealizable, while the switch to retained earnings is an indication that the loss is likely to realize, this accounting choice could lead to a reduction on stock price. The coefficient for the binary variable *Optional exemption* restricted to cumulative losses is not significant (-28.054; $p < 0.332$), suggesting that the switch of cumulative translation losses to retained earnings do not affect stock market assessment of equity multiple.

4.4   Endogeneity between an accounting exemption decision and stock market assessment

Our results are not substantially affected by endogeneity. Hence, even though we do not reject the null hypothesis of no endogeneity for IFRS No. 2 and IAS No. 21, results remain quite similar relying on Ordinary Least Square Regressions. For the price model, the coefficients for market assessment of accounting choices are similar to a treatment effect procedure. However, the treatment effect procedure appears to generate a better-specified model since the coefficients for variables Operating cash flow per share and Accruals per share are always significant while they are not significant in OLS regressions for IAS No. 19, and IAS No. 39.

[Insert table 2B]

4.5   Stock market valuation of optional exemption adjustments compared to mandatory application of IFRS

Table 3 presents results of OLS regressions that assess 1) how stock markets impounds IFRS equity adjustments for first-time adopters, and 2) whether optional exemptions are valued differently than mandatory opening IFRS equity adjustments.

For all five regression models, results show that IFRS Equity adjustment presents statistically higher equity multiples to assess stock price since F test estimation of equality of $ß_1$ (Equity per share less IFRS equity adjustment) and $ß_2$ (IFRS equity adjustment less Optional exemption) is statistically insignificant for all five regressions (F test p value varying from 0.442 to 0.686). This finding is in line with Asbaugh and Pincus (2001) results.

Concerning market valuation of optional exemptions, consistent with results presented in tables 2A and 2B, our results suggest that French market participants are in a position to discriminate between local accounting standards, mandated IFRS and voluntary IFRS choices (optional exemption adjustments). Hence, the only optional exemption adjustment that seems to be valued by stock markets concerns IAS No. 19 on the recognition of actuarial gains and losses. The positive and significant coefficient for the variable *Equity-Optional exemption adjustment* (0.715; $p < 0.10$) would suggest that stock market participants have difficulties to interpret the impact of that transition choice.

This result is consistent with table 2A (equation 2) since the coefficient for the interaction term *Equity per share*Optional exemption decision* is not significant, which means that equity per share, already affected by this accounting choice is not valued differently for firms not opting for that choice.

Moreover, consistent with our prediction, we observe that first-time adopter that chose to apply IFRS No. 2 to equity instruments granted after November 2002 that vested before the date of the transition exhibit larger earnings in 2005 and that market participants see through earnings numbers as expressed by the coefficient for the interaction term *Earnings per share*Optional exemption decision* (-5.638; $p < 0.05$). This finding is consistent with Aboody, Barth and Kasznik (2004) who show that investors view SFAS No. 123 compensation expense as an expense for the firm, and as sufficiently reliable to be reflected in their valuation assessments.

[Insert table 3]

4.6   Accounting choices independence

In this paper, we treat different accounting choices separately. However, these choices are likely to be part of a global reporting strategy. Results from a correlation analysis (table 4) suggest that the decision to opt for a particular exemption seems to be relatively independent from other choices. Only choices related to IAS No. 19 and IAS No. 21 (0.342), and IAS No. 19 and IFRS No. 2 (0.251), are significantly correlated. An explanation for the correlation between IAS No. 19 and IAS No. 21 is the fact that all

firms except one that opt for optional exemption of IAS No. 19 exhibit actuarial losses and 90% (78 out of 87 firms) of firms opting for exemption of IAS No. 21 exhibit cumulative exchange losses. Concerning the correlation between IAS No. 19 and IFRS No. 2, an explanation could be that the presence of stock options creates an incentive for earnings management, i.e. switch losses from future periods to the current period.

[Insert table 4]

5.   Conclusion

This paper investigates managers' incentives to elect for optional exemptions allowed at first-time adoption of IFRS adoption as well as French stock market assessment of such choices. Relying on a system of equations that controls for endogeneity between IFRS optional exemptions and French stock market assessment, our results suggest that optional exemptions are determined by a firm's contracting costs and benefits.

More specifically, regarding the incentives for optional exemptions, first, the switch of cumulative actuarial losses to retained earnings is related to the presence of stock options, leverage, and to a lesser extent to analyst following. This accounting choice is likely to reduce bad news announcement in the future. Second, in the presence of stock options, leverage, concentrated ownership and analyst following are positively associated with the retrospective recognition of stock option expense while the opposite is true for return on assets and institutional investors. This earnings management tool is used for highly

levered firms and firms followed by analyst and firms with lower profitability. Third, the anticipation of IAS No. 39 is positively related to the presence of stock options, size, and foreign listing. These findings suggest that optional exemption adopters share common characteristics, especially concerning IAS No. 19, IAS No. 39 and IFRS No. 2.

Concerning the stock market assessment of these accounting choices, results generally suggest that French stock markets are able to assess the impact of these optional exemptions on financial statements. The exception is the first-time adopter who elects to recognize all cumulative actuarial losses at the date of transition to IFRS. Our result would suggest that stock market participants have difficulties to interpret the impact of that transition choice. This result is consistent with Barth, Beaver and Landsman (1992) findings that amortization components of pension obligations such as actuarial gains and losses do not have any value for stock markets. Overall, our results suggest that market assessment regarding IFRS adoption is consistent. Hence, even though accounting choices surrounding IFRS adoption are not exempt from both contracting and market incentives, it seems that stock markets are in a position to assess the incidence of these choices on financial statements.

Moreover, French market participants seem to be in a position to discriminate between French GAAP, mandated IFRS and voluntary IFRS choices. Hence, the only optional exemption that seems to be valued by stock markets concerns IAS No. 19 on the recognition of actuarial losses.

This paper's findings may be of importance for local accounting standard setting bodies that are considering adopting IFRS in a near future. This is the case for countries such as Canada, and perhaps the United States, at least for cross-listed firms. Among its potential limitations, at least two aspects must be mentioned. In this paper, we treat different accounting choices separately. However, an accounting choice is likely to be part of a global reporting strategy, i.e., not independent from other accounting choices. Another limitation of our study is our sample size. Since we had to collect manually information from annual reports, we had to trade-off between the cost of data collection and the benefits of sample representativeness. However, even though the small sample size can reduce the power of the empirical analyses, given that our sample takes in two-thirds of French stock market capitalisation, we think that our results can still be considered as meaningful.

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Table 1
Descriptive statistics

	Minimum	Maximum	Mean	Std Dev.
Stock price (year-end in €)	1.81	465	58.56	63.07
Market-to-book	0.11	17.26	2.96	2.85
Equity per share (in €)	0.90	181.77	27.26	27.17
Operating cash flow per share (in €)	-0.87	139.60	7.20	14.11
Accruals per share (in €)	-132.18	10.25	-3.62	12.98
Earnings per share (in €)	-7.64	30.29	3.54	4.31
Stock options	0	1	0.88	0.33
Leverage (long term debt/Total assets)	0	0.73	0.16	0.13
Analyst following	5	61	25.00	10.87
Concentrated ownership (more than 10%)	0	1	0.56	0.49
Institutional ownership	0	1	0.38	0.49
Return on assets (%)	-9.28	18.99	4.71	4.35
Foreign listing	0	1	0.21	0.41
Firm's size (Total assets in million €)	326	1 258 080	54 385	185 312
IFRS equity adjustment per share (in €)	-296.21	133.84	0.34	43.40
IFRS equity adjustment per share for optional exemption (in €)				
IAS16-40	-2.789	8.324	0.280	1.292
IAS19	-24.803	0.041	-1.126	3.110
IAS21	-17.438	2.382	-1.018	2.809
IAS39	-1.569	10.232	0.114	1.086
Optional exemption decision				
IAS16-40	0	1	0.22	0.42
IAS19	0	1	0.76	0.43
IAS21	0	1	0.81	0.37
IFRS2	0	1	0.79	0.41
IAS39	0	1	0.48	0.50
N: 107				

Table 2A
Treatment Effect Regression Model of the Impact of
Optional exemption choices on the Stock Market Value

Optional exemption $decision_{it}$ =

f($ß_0$ + Stock options + $ß_1$ Firm's size + $ß_2$ Leverage + $ß_3$ Analyst following + $ß_4$ Concentrated ownership + $ß_5$ Institutional ownership + $ß_6$ Return on assets + $ß_7$ Foreign listing + $ß_8$- $ß_{17}$ $Industry)_{it}$ (1)

Stock $price_{it}$ =

f($ß_0$ + Equity per share + $ß_1$ Equity per share*Optional exemption decision + $ß_2$ Optional exemption decision + $ß_3$ Operating cash flow per share + $ß_4$ Accruals per $share)_{it}$ (2)

		IAS16-40	IAS19	IFRS2	IAS39	IAS21
Equation 1 *Dependent variable: Optional exemption decision*						
Stock options	+/-	*0.956	***1.152	--	***6.996	0.117
Leverage	+/-	2.088	***3.051	**4.276	1.593	-0.766
Analyst following	+/-	-0.010	*0.637	**1.217	0.010	0.022
Concentrated ownership	+/-	***0.829	-0.274	**0.726	0.237	-0.057
Institutional ownership	+/-	0.129	0.153	***-1.004	-0.084	0.118
Return on assets	+/-	0.049	-0.024	**-0.098	0.014	**-0.080
Foreign listing	+/-	-0.098	0.159	-0.636	***1.544	0.512
Firm's size	+/-	0.068	0.082	-0.227	***-0.224	*0.188
Equation 2 *Dependent variable: Stock price*						
Equity per share	+	***1.358	*0.842	***0.841	***1.363	***1.229
Equity per share*Optional exemption decision	+/-	*-0.624	0.314	-	*-0.615	-
Operating cash flow per share	+	*2.210	**2.429	***2.978	*2.019	*2.234
Accruals per share	+	**2.526	**2.436	**1.978	*2.269	*2.454
Optional exemption decision	+/-	9.879	16.791	-15.361	11.311	-28.054
Wald Ch2		68 (0.00)	66 (0.00)	117.8 (0.00)	63(0.00)	63 (0.00)
Lambda (prob.)		4.1 (0.842)	6.9 (0.655)	15.4 (0.249)	1.4 (0.922)	25.4 (0.156)
N:		105	107	98	102	103

Two-step Estimates
Intercept and Industry dummies not reported.
*: $p < 0.10$; **: $p < 0.05$; ***: $p < 0.01$. One-tailed if there is a predicted sign, two-tailed otherwise.

Table 2B
Ordinary Least Square Regression Model of the Impact of
Optional exemption choices on the Stock Market Value

Stock price$_{it}$ =

f(ß$_0$ + Equity per share + ß$_1$ Equity per share*Optional exemption decision + ß$_2$ Optional exemption decision + ß$_3$ Operating cash flow per share + ß$_4$ Accruals per share)$_{it}$ (2)

		IAS16-40	IAS19	IFRS2	IAS39	IAS21
Equation 2 *Dependent variable:* *Stock price*						
Equity per share	+	***1.647	**0.818	***0.846	**1.363	***1.169
Equity per share*Optional exemption decision	+/-	**-0.954	0.371	-	*-0.614	-
Optional exemption decision	+/-	21.487	-3.472	-6.779	9.067	8.126
Operating cash flow per share	+	**2.728	2.307	**3.114	2.065	**2.674
Accruals per share	+	**3.048	2.361	**2.208	2.314	**2.945
R-Square		64.7%	38.2%	55.8%	36.3%	36.1%
F-Statistic		39.5(0.000)	11.3(0.000)	29.2(0.000)	10.5(0.000)	14.4(0.000)
N:		105	107	98	102	103

Intercept not reported.

*: $p < 0.10$; **: $p < 0.05$; ***: $p < 0.01$. One-tailed if there is a predicted sign, two-tailed otherwise.

Table 3
Ordinary Least Square Regression Model of the Impact of
Optional exemption amount on the Stock Market Value

Stock price$_{it}$ =

f(ß$_0$ + ß$_1$Equity per share less IFRS equity adjustment + ß$_2$IFRS equity adjustment less Optional exemption adjustment + ß$_3$ Optional exemption adjustment + ß$_4$ Earnings per share)$_{it}$ (3)

		IAS16-40	IAS19	IFRS2	IAS39	IAS21
Equation 3 *Dependent variable: Stock price*						
Equity per share less IFRS equity adjustment	+	***1.087	***1.068	***1.029	***1.107	***0.973
IFRS equity adjustment – net of optional exemption	+	***1.142	***1.096	***1.082	***1.182	***1.003
Equity adjustment - Optional exemption	+/-	2.119	*0.715	-	-6.214	-1.126
Earnings per share		***4.823	***4.552	***8.856	***4.758	***4.899
Earnings per share*optional exemption decision				**-4.268		
R-Square		54.9%	54.95%	55.9%	55.9%	53.2%
F-Statistic		30.6(0.000)	32.6(0.000)	31.7(0.000)	32.7(0.000)	27.2.000)
F test of equality between coefficient ß$_1$ and ß$_2$		0.16 (0.0.686)	0.20(0.652)	0.17(0.679)	0.18(0.673)	0.60(0.442)
N:		107	107	98	107	95

Intercept not reported.

*: $p < 0.10$; **: $p < 0.05$; ***: $p < 0.01$. One-tailed if there is a predicted sign, two-tailed otherwise.

Table 4
Correlation matrix
Optional exemption decision

	Stock price	IAS No. 16-40	IAS No. 19	IFRS no. 2	IAS No. 39	IAS no. 21
IAS No.16-40	-0.119	1				
IAS No. 19	0.102	0.096	1			
IFRS No. 2	0.094	-0.059	0.251	1		
IAS No. 39	-0.209	0.070	0.104	0.189	1	
IAS No. 21	0.089	-0.029	0.319	0.112	0.026	1