

The Impact of Turning Away from IFRS on Earnings Quality of U.K. Private Firms

Yu-Lin Hsu

University of Glasgow

Ya-Chih Yang

National Cheng Kung University

ABSTRACT: New U.K. GAAP follows the design of IFRS and IFRS for Small and Medium-Sized Entities (SMEs) and was introduced from 2015 to improve the comparability and quality in financial reporting and to reduce disclosure costs. This new standard heavily affected the financial reporting of private firms. To help assess whether the goal of Financial Reporting Council is achieved, this study examines whether switching from IFRS to new U.K. GAAP is associated with private companies' earnings quality. We use U.K. private firm data during 2015–2018 to conduct difference-in-differences and regression analyses. Overall, the results suggest that the switch from IFRS to new U.K. GAAP does not have significant impact on accruals quality, but reduces the timely loss recognition. This study contributes to the ongoing debate over the design of financial reporting standards for private firms and SMEs and provides useful evidence for evaluating new U.K. GAAP and IFRS for SMEs.

JEL Classifications: M4; M41; M48.

Keywords: earnings quality; IFRS; SMEs; IFRS for SMEs; new U.K. GAAP; private firms.

I. INTRODUCTION

Although the adoption of the International Financial Reporting Standards (IFRS) was mandatory for U.K. listed firms' consolidated accounts since 2005, U.K. private firms can still choose between the IFRS and the Generally Accepted Accounting Principles in the U.K. (U.K. GAAP). Most of the U.K. private firms prefer the U.K. GAAP to the IFRS. For example, as shown in [Appendix B](#), private firms that used the U.K. GAAP throughout the 2013–2015 period account for 89.59 percent of the total observations. To improve the comparability (between private firms and publicly listed firms) and the quality in financial reporting, the Financial Reporting Council (FRC) introduced a new U.K. GAAP, which replaced the old U.K. GAAP, from 2015 ([Financial Reporting Council \(FRC\) 2014](#); [PwC 2013](#)). Like the IFRS for Small and Medium-Sized Entities (IFRS for SMEs), the new U.K. GAAP is designed to be more aligned to the IFRS (in terms of accounting treatments and methods), but with substantially reduced disclosures than the IFRS.¹ Therefore, compared to the old U.K. GAAP, the new U.K. GAAP has accounting treatments that are more consistent with the IFRS. Furthermore, rather than using the methods under the IFRS for SMEs directly, the FRC changed some requirements to make the new U.K. GAAP more consistent with the IFRS

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Yu-Lin Hsu, University of Glasgow, Adam Smith Business School, Accounting and Finance Subject Group, Glasgow, United Kingdom; Ya-Chih Yang, National Cheng Kung University, College of Management, Department of Accountancy, Tainan, Taiwan.

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¹ Please note that U.K. private firms are not allowed to adopt the IFRS for SMEs.

(Association of Chartered Certified Accountants (ACCA) 2019; PwC 2013). The FRC also maintained certain requirements of the old U.K. GAAP in the new U.K. GAAP to suit the U.K. practice better (PwC 2013). Accordingly, different from the IFRS for SMEs, the new U.K. GAAP is a mixture of the IFRS for SMEs, the IFRS, and the old U.K. GAAP. With the new U.K. GAAP, the FRC also aims to tackle the high financial reporting costs associated with the IFRS, which are often criticized by practitioners and scholars (Bassemir 2018). This regulatory change heavily affected the financial reporting of U.K. private firms.

It is observed (see Appendix B) that in private firms that voluntarily adopted the IFRS, the rate of turning away from the IFRS (and adopting the U.K. GAAP) in 2015 (30.70 percent; 1,721 switched firms) is almost double that in 2014 (15.93 percent; 777 switched firms). These figures suggest that a large proportion of private firms that voluntarily adopted the IFRS before may find the new U.K. GAAP, which is designed to be more aligned to the IFRS in accounting treatments (compared to the old U.K. GAAP) and requires less disclosure than the IFRS, attractive.

There is a consensus that the IFRS is costly to use, although it is often deemed as having higher quality compared to the local GAAP (Barth, Landsman, and Lang 2008; Bassemir 2018). Therefore, regulators continuously explore whether reduced IFRS frameworks, such as the IFRS for SMEs and the new U.K. GAAP, help to provide a solution (Damak-Ayadi, Sassi, and Bahri 2020). Similarly, through introducing the new U.K. GAAP, the FRC aims to reduce companies' financial reporting costs, while not sacrificing the financial reporting quality (FRC 2014), which is crucial for shareholders and lenders in decision-making. Therefore, it is important to understand whether the switch from the IFRS to the new U.K. GAAP affects companies' earnings quality. Currently, the empirical evidence on reduced IFRS frameworks is still limited (Gonçalves, De Moura, and Motoki 2022). Hence, this research focuses on U.K. private firms that voluntarily adopted the IFRS before and aims to investigate whether the switch from the IFRS to the new U.K. GAAP is associated with earnings quality, to contribute to accounting literature, and to provide useful insights for policymakers to evaluate potential consequences of using reduced IFRS frameworks.

Previous literature suggests that the change to new accounting standards and reduced disclosures (therefore reduced transparency) may lead to higher information asymmetry (Capkun, Collins, and Jeanjean 2016; Tsalavoutas and Dionysiou 2014). Based on agency theory, managers may use this opportunity to manage earnings, to increase their bonuses (Cotter, Lokman, and Najah 2011), or for tax-saving purposes (Cameran, Campa, and Pettinicchio 2014). If the switch from the IFRS to the new U.K. GAAP is mainly driven by opportunistic behavior and if the new U.K. GAAP cannot effectively constrain earnings management, it is more likely to observe a significant change in earnings quality after the switch. However, companies may switch to the new U.K. GAAP for other reasons. For instance, firms may switch from the IFRS to the new U.K. GAAP to simply enjoy the benefits of reduced discloses and costs (for example, the reduced time to prepare financial reports or proprietary costs) under the new U.K. GAAP (PwC 2013), without the intention to manage earnings. This incentive can be explained by rational choice theory (Scott 2000); that is, firms switch to the new U.K. GAAP because they perceive net benefit from doing so. If the switch to the new U.K. GAAP mainly aims to reduce costs, rather than to manage earnings, there will be less impact on earnings quality after the switch. This paper will help to understand the rationale behind this accounting choice.

Furthermore, if the new U.K. GAAP is well designed in the way that the FRC claimed (that is, being a high-quality standard similar to the IFRS, but with fewer disclosures than the IFRS) and can effectively constrain earnings management, there should not be a significant change in earnings quality after firms switch from the IFRS to the new U.K. GAAP. Hence, to assess whether the new U.K. GAAP helps to achieve the FRC's goal (that is, to enhance the financial reporting quality with reduced disclosure levels), this paper will investigate whether the turning away from the IFRS (and adopting the new U.K. GAAP) affects earnings quality. The high cost of using the IFRS, particularly for smaller firms, is often criticized, and there is an ongoing discussion on potential solutions (Bassemir 2018). As indicated above, most of the U.K. private firms choose to use the U.K. GAAP, rather than the IFRS. The low percentage of voluntary IFRS adoption suggests that the IFRS may still be too costly, particularly for private and smaller firms. This situation is also observed in other countries (Christensen 2012). Hence, it is important to investigate whether a reduced framework of IFRS may help. The U.K. setting allows the investigation of whether a reduced IFRS framework, like the new U.K. GAAP or the IFRS for SMEs, can help to solve this issue. Specifically, if the switch from the IFRS to the new U.K. GAAP does not significantly affect firms' earnings quality, this implies that the new U.K. GAAP could help to achieve an earnings quality level similar to the IFRS, in a more cost-effective way. This is the first study to investigate the impact of the new U.K. GAAP on private firms' earnings equality. The setting used in this study (namely, the switch from the IFRS to the new U.K. GAAP) is also unique, as most of the existing literature discusses the switch from the local GAAP to the IFRS, and it helps in understanding the difference between the IFRS and reduced IFRS frameworks better. The results will help to inform accounting regulators, including the FRC and others, considering the introduction of similar standards like IFRS for SMEs and relevant stakeholders, such as

lenders and other companies, about the potential consequences of this new standard. The results will have important policy impact.

A significant amount of literature, focusing on public companies, discusses the relationship between the adoption of the IFRS and earnings quality (Burnett, Gordon, Jorgensen, and Linthicum 2015; Chen, Tang, Jiang, and Lin 2010; Daske and Gebhardt 2006; Jeanjean and Stolowy 2008; Gebhardt and Novotny-Farkas 2011; Tsalavoutas and Evans 2010), but the findings have been inconsistent. Some scholars document a lower level of earnings management² for IFRS users (Barth et al. 2008; Chen et al. 2010; Zeghal, Chtourou, and Fourati 2012). Others question the usefulness of the IFRS in enhancing the quality of financial reporting (Burnett et al. 2015; Paananen and Lin 2009; Van Tendeloo and Vanstraelen 2005) and indicate that the IFRS adoption can reduce earnings quality (Cameran et al. 2014; Jeanjean and Stolowy 2008). This shows that local GAAP can also be of high quality. Since local GAAP is applicable to the majority of private firms across the world and to public firms in certain countries, such as the U.S., understanding whether the switch from the IFRS to the new U.K. GAAP, which is mainly designed to be consistent with the IFRS for SMEs, but requires fewer disclosures than the IFRS and incorporates certain requirements of the old U.K. GAAP, influences the earnings quality (that is, the aim of this paper) will provide useful insights into accounting convergence. Our results will be relevant to private firms in the U.K. and in other countries and to public firms in some countries where the IFRS is not yet fully adopted (such as the U.S. and China). Although the IFRS for SMEs is an emerging research area (Damak-Ayadi et al. 2020; Gassen 2017), the understanding of its impact on firms is very limited. Recent literature has urged future research to study how the IFRS for SMEs affects companies and accounting practice (Ajekwe and Ibiameke 2020; Arafat, Dunne, and Ahmed 2020). As far as we know, none of existing literature analyzes the impact of the IFRS for SMEs on earnings quality, which is crucial to evaluating the quality of an accounting standard (Ahmed, Neel, and Wang 2013). This study will contribute to the debate about the applicability of the IFRS or this IFRS for SMEs to private firms, and the accounting practices of these firms, by showing whether the new U.K. GAAP, which shares the similar aims of the IFRS for SMEs, is comparable to the IFRS in terms of earnings quality (Bar-Yosef, D'Augusta, and Prencipe 2019; Hope, Thomas, and Vyas 2017).

Furthermore, the incentives for private firms to manage earnings are different from those for public firms. Beatty and Harris (1999) show that private firms that are less concerned about information asymmetry than public firms have relatively little incentive to manage earnings. However, Ball and Shivakumar (2005) argue that private firms conduct more earnings management activities than public firms due to lower external pressure. They suggest that private firms' financial reporting is mainly driven by the tax or dividend policies. Similarly, Bar-Yosef et al. (2019) point out that tax consideration is the key factor affecting the accounting choices of private firms, which face less pressure to reduce information asymmetry through financial reporting than public companies. Despite the economic significance of private firms (e.g., they are the major job providers, and the majority of businesses are private, rather than public) and the distinction between them and public companies in financial reporting, far too little attention has been paid to analyzing their decisions in accounting (Ball and Shivakumar 2005; Bassemir and Novotny-Farkas 2018; Clatworthy and Peel 2016). This paper will help to provide further evidence on private firms' earnings quality.

Following previous studies (Ball and Shivakumar 2005; Barth et al. 2008; Cameran et al. 2014; Dechow, Sloan, and Sweeney 1995; DeFond and Park 2001), this paper measures four proxies of earnings quality: abnormal working capital accruals, discretionary accruals, timely loss recognition, and income smoothing. The difference-in-differences (DiD) analysis shows that the switch from the IFRS to the new U.K. GAAP does not significantly affect companies' accruals quality, but reduces the timely loss recognition. The results regarding the impact of switching accounting standards on income smoothing behaviors are inconclusive. These results imply that the new U.K. GAAP, designed to be more aligned to the IFRS in accounting treatments, is compatible with the IFRS in terms of accruals quality. However, differences between the new U.K. GAAP and the IFRS (e.g., in disclosure levels and certain accounting treatments, as the new U.K. GAAP also contains treatments of the IFRS for SMEs and the old U.K. GAAP) still affect companies' earnings quality in terms of timely loss recognition and income smoothing. The finding also suggests that accounting regulators should trade off among different good characteristics of financial reporting (Scott 2015), and, hence, it is important, particularly for countries considering incorporating requirements of local GAAP when introducing the IFRS or a reduced IFRS framework, to determine which good characteristic is more important for private firms, as well as public firms.

This paper has been organized in the following way. Section II gives an overview of the new U.K. GAAP and discusses relevant literature. Section III describes the sample and research method. Section IV analyzes the results. Section V concludes this study.

² Although earnings management can be good or bad, we follow prior studies related to IFRS adoption (Barth et al. 2008) and regard firms engaging in less earnings management as those have better earnings quality.

II. LITERATURE REVIEW AND HYPOTHESIS

Background

Background of the New U.K. GAAP

U.K.-listed companies have to adopt the IFRS for their consolidated financial statements from 2005. However, U.K. private firms can choose whether to adopt the IFRS voluntarily. As mentioned earlier, most U.K. private firms choose to use the U.K. GAAP. This situation is not just seen in the U.K., but also in many other countries. There is ongoing discussion on whether private or smaller firms should also adopt the IFRS to enhance the comparability and quality of financial reporting. The high compliance cost of using the IFRS is often the center of this discussion, and this high cost often makes smaller firms unable to obtain net benefits from adopting the IFRS (Bassemir 2018; Christensen 2012). Hence, the later IFRS for SMEs, which follows the concepts of the IFRS, but requires fewer disclosures, is designed to solve this issue (Gassen 2017).

With the similar aims of the IFRS for SMEs (that is, being more consistent with the IFRS, but substantially reducing disclosure costs compared to the IFRS), the new U.K. GAAP was introduced by the FRC and replaced the old U.K. GAAP from 2015 (FRC 2014; PwC 2013). Two key standards under the new U.K. GAAP are Financial Reporting Standard 101 (FRS 101), “Reduced Disclosure Framework,” and Financial Reporting Standard 102 (FRS 102), “The Financial Reporting Standard Applicable in the UK and Republic of Ireland.” FRS 101 provides a reduced disclosure framework of the IFRS and allows qualifying companies exempt from (or reduce) certain disclosures required by IFRS, such as “the statement of cash flows” and “intangible properties” (Ernst & Young 2013; Financial Reporting Council (FRC) 2018). Companies reporting under FRS 101 would use the recognition and measurement bases of the IFRS, while enjoying the significantly reduced disclosure level (PwC 2013). FRS 102 is the mixture of the IFRS, the IFRS for SMEs, and the old U.K. GAAP. It was designed to be consistent with the IFRS and the IFRS for SMEs in terms of accounting treatments, while maintaining parts of the old U.K. GAAP. FRS 102 is mainly based on the IFRS for SMEs, which simplified IFRS requirements. However, instead of using the requirements of the IFRS for SMEs directly in developing the new U.K. GAAP, the FRC changed some requirements of the IFRS for SMEs (such as removing undue cost or effort exemptions), to make FRS 102 more aligned to IFRS in accounting treatments (ACCA 2019; PwC 2013). By doing so, the FRC aims to ensure the high quality of financial reporting under this new standard (PwC 2013). Furthermore, FRS 102 incorporates some requirements of the old U.K. GAAP to suit the U.K. practice better (PwC 2013).³ As a result, there are still key differences between FRS 102 and the IFRS. For example, under FRS 102, companies can determine to capitalize or expense development costs and borrowing costs. However, these costs should be capitalized under the IFRS (PwC 2013). Additionally, goodwill is amortized under FRS 102, but not under the IFRS (PwC 2015). Moreover, the treatment of business combinations under FRS 102 is similar to that under the old U.K. GAAP (for example, companies may use merger accounting) and is different from that under the IFRS (PwC 2015). In addition, the fair value model is not so widely applied under FRS 102 as it is under the IFRS (PwC 2015). Overall, compared with the old U.K. GAAP, the new U.K. GAAP (including both FRS 101 and FRS 102) is more aligned to the IFRS in accounting treatments and methods. Different from the IFRS, the new U.K. GAAP requires a much lower disclosure level (PwC 2013). Furthermore, although the new U.K. GAAP is designed based on the IFRS for SMEs, it incorporates some accounting treatments of the IFRS and the old U.K. GAAP (ACCA 2019; PwC 2013).

As noted earlier, 30.70 percent of U.K. private firms that voluntarily adopted the IFRS before switched to the new U.K. GAAP in 2015 (that is, 1,721 switched firms) when this new standard replaced the old one. The sudden increase in the number of U.K. private firms that switched from the IFRS to the new U.K. GAAP may suggest that the new U.K. GAAP, which is more consistent with the IFRS and the IFRS for SMEs, and requires less disclosure, is attractive for these firms. If there is no significant change in earnings quality following the switch of accounting standards, the new U.K. GAAP may be helpful, as what the FRC claims, for improving the earnings quality with reduced disclosures. Therefore, this research will focus on U.K. private firms that voluntarily adopted the IFRS before and investigate whether the choice to switch from the IFRS to the new U.K. GAAP is associated with firms’ earnings quality.

Literature on the IFRS for SMEs

The IFRS for SMEs is an emerging research area in accounting (Arafat et al. 2020; Gassen 2017). Some scholars focus on the country-level adoption of the IFRS for SMEs, discussing the relationship between country attributes and the adoption decision and the standard-setting process (Arafat et al. 2020; Damak-Ayadi et al. 2020). Others analyze

³ However, the new U.K. GAAP and the old U.K. GAAP still have very different requirements in several aspects, such as the treatments for financial instruments, employee benefits, investment property, and intangible assets (PwC 2013).

the IFRS for SMEs at the firm level. For example, [Litjens, Bissessur, Langendijk, and Vergoossen \(2012\)](#) measure the expected costs and benefits of using the IFRS for SMEs, using survey data obtained from Dutch private firms. Similarly, [Eierle and Haller \(2009\)](#) use survey data on German firms to investigate firms' anticipated costs and benefits of adopting the IFRS for SMEs. They indicate that many of the sampled firms do not find the IFRS for SMEs beneficial. Also using survey data, [Kiliç, Uyar, and Ataman \(2016\)](#) investigate how well Turkish private SMEs are prepared for the IFRS for SMEs and find that larger firms tend to be more well prepared. These firm-level studies mainly discuss the potential adoption of the IFRS for SMEs, rather than the consequences of the adoption. So far, the implications and consequences of the IFRS for SMEs on firms are unclear due to the lack of empirical evidence ([Ajekwe and Ibiameke 2020](#); [Arafat et al. 2020](#)). This may be because of the difficulty in obtaining data of private firms who are the key users of the IFRS for SMEs. This paper aims to fill this research gap by analyzing the impact of (turning away from the IFRS and) adopting the new U.K. GAAP, whose design follows the similar idea of the IFRS for SMEs, on earnings quality.

Earnings Quality, Accounting Standards, and Private Firms

Earnings Management in Private Firms

Because previous literature shows that firms may manage their earnings through accounting choices and their incentives for adopting accounting standards affect the subsequent earnings quality ([Capkun et al. 2016](#); [Christensen, Lee, Walker, and Zeng 2015](#)), this section aims to provide background information on earnings management in private firms (including their incentives to manage earnings). As stated earlier, there has been relatively little discussion about financial reporting of private firms, which are the main contributors of economies. [Nagar, Petroni, and Wolfenzon \(2011\)](#) reveal that shareholders of private firms are usually involved with operation management, and, thus, these firms have a lower level of agency problem, which may imply a very different behavior in financial reporting from public firms. The consideration for tax or dividend, rather than external investors, could dominate the accounting choices of private firms ([Ball and Shivakumar 2005](#)) and, therefore, could be their important incentives to manage earnings. Furthermore, [Cameran et al. \(2014\)](#) explain that the conflict of interest between lenders (for example, banks) and managers or managers' personal incentives (such as increasing their own bonuses) could lead to earnings management in private firms. Recent literature further documents that CEO characteristics, such as gender and age, will affect the level of earnings management. For example, private firms with female CEOs tend to employ less earnings management compared to firms with male CEOs ([Belot and Serve 2018](#)).

Several previous literatures compare the earnings management activities of private and public companies and indicate that evidence on earnings management is mixed. Some research shows that private firms with fewer agency problems have less incentive to manage their earnings ([Beatty and Harris 1999](#)). On the other hand, [Burgstahler, Hail, and Leuz \(2006\)](#) argue that private firms with less pressure from investors and regulators will manage their earnings more often. Similarly, [Coppens and Peek \(2005\)](#) prove that European private firms tend to adjust their earnings when encountering a small amount of losses. [Ball and Shivakumar \(2005\)](#) also show that private firms do not recognize their losses as timely as public companies. Our research will add to current literature by analyzing whether the decision of private firms to abandon the IFRS is associated with earnings management ([Bassemir 2018](#); [Fiechter, Halberkann, and Meyer 2018](#)).

Earnings Quality and the Choice of Accounting Standards

Theoretical framework. As indicated earlier, the new U.K. GAAP requires a much lower disclosure level than the IFRS does. The new U.K. GAAP and the IFRS also have several major differences, such as in the treatment of development costs and borrowing costs and in the use of the fair value model ([PwC 2015](#)). Therefore, when private firms switch from the IFRS to the new U.K. GAAP, they may experience lower disclosure levels and lower financial reporting costs. The differences between the new U.K. GAAP and the IFRS in terms of accounting treatments would also mean that private firms may need to apply different accounting methods (e.g., in treating development costs and borrowing costs) when they switch from the IFRS to the new U.K. GAAP. The introduction of new accounting standards and the reduced disclosure level (and, hence, reduced transparency) under the new U.K. GAAP may provide an opportunity for earnings management ([Capkun et al. 2016](#); [Tsalavoutas and Dionysiou 2014](#)). From the perspective of agency theory ([Cotter et al. 2011](#)), the information asymmetry may be higher when a new set of accounting standards was just introduced and people were still not very familiar with the new standards. The reduced disclosure level under the new U.K. GAAP may also increase information asymmetry. In this situation, managers may take this opportunity and change the accounting standard to aggressively manage earnings. For example, managers may do so to increase their bonuses, to resolve the conflict of interest between them and lenders, or to save tax ([Cameran et al. 2014](#)). If the switch to the new U.K. GAAP is mainly to aggressively manage earnings and if the design of the new U.K. GAAP is not able to

effectively constrain earnings management, we will expect a significant change in earnings quality after the switch from the IFRS to the new U.K. GAAP.

However, companies may also switch from the IFRS to the new U.K. GAAP for reasons other than earnings management. As the new U.K. GAAP is particularly designed to reduce the disclosure level (PwC 2013), a potential benefit for firms to switch from the IFRS to the new U.K. GAAP will be the reduced costs (such as the cost and time of preparing financial reports) following the reduced disclosures. The proprietary cost theory further suggests that the switch from the IFRS to the new U.K. GAAP can also benefit firms through not disclosing too much information to their competitors (Cotter et al. 2011). From the perspective of rational choice theory (Scott 2000), managers will consider costs and benefits when making accounting choices. Under rational choice theory, firms will switch to the new U.K. GAAP if the related benefit is greater than the cost (for example, transition costs, the amount of which we expect will be subtle, as the new U.K. GAAP is designed to be closely aligned to the IFRS). Managers may simply choose to switch from the IFRS to the new U.K. GAAP to enjoy the reduced disclosure and lower financial reporting costs, rather than to aggressively manage earnings. If U.K. private firms' decision to switch to the new U.K. GAAP is mainly driven by the reduced disclosure and costs associated with the new U.K. GAAP and the design of the new U.K. GAAP ensures high-quality reporting, there may be little impact on earnings quality after the switch.

Empirical literature. Much of the extant literature focuses on the earnings management associated with the IFRS adoption (André, Filip, and Paugam 2015). Some studies prove that the IFRS helps to improve the earnings quality (Barth et al. 2008; Hung and Subramanyam 2007; Tsalavoutas and Evans 2010). Barth et al. (2008) and Chen et al. (2010), using cross-country data, show that adopters of the International Accounting Standards (IAS) have less earnings management and better earnings quality. Daske and Gebhardt (2006), based on the data of scholars' rating, conclude that the IFRS adoption is helpful for improving the earnings quality. Using German private firm data, Bassemir and Novotny-Farkas (2018) document a positive relationship between IFRS adoption and earnings quality for younger and high-growth firms. They further indicate that firms' incentives play an important role in whether IFRS adoption could enhance earnings quality.

Other researchers show that IFRS adoption does not guarantee a better quality of financial reporting (André et al. 2015). Soderstrom and Sun (2007) point out that the incentives of adopting the IFRS, as well as institutional environment and the accounting standards *per se*, together determine the earnings quality after the adoption. Likewise, Jeanjean and Stolowy (2008) confirm the crucial role of corporate incentives and the legal environment during the IFRS adoption and document a decrease in earnings quality in France after the IFRS adoption. Furthermore, using cross-country data, Houque, van Zijl, Dunstan, and Karim (2012) demonstrate that a strong investor protection is necessary to enhance firms' earnings quality in the post-IFRS period. Cameran et al. (2014) also show that Italian private firms experience a lower earnings quality after the IFRS adoption. Previous literature also indicates that fair value accounting, which is widely used under the IFRS and requires managers' judgment, may be used as an earnings management tool (Dechow, Myers, and Shakespeare 2010). This may also explain why IFRS adoption is not always associated with higher earnings quality.

Rather than examine the accounting policy choices of firms that switch from the local GAAP to the IFRS, this study will focus on the change from the IFRS to the new U.K. GAAP (which is designed based on the IFRS for SMEs, but incorporates certain accounting treatments of the old U.K. GAAP and the IFRS) and on the choice made by firms with prior IFRS experience. Since previous research findings into whether IFRS adoption can lead to a better quality of financial reporting have been inconsistent and evidence on private firms is limited (Brüggemann, Hitz, and Sellhorn 2013; Cameran et al. 2014; Soderstrom and Sun 2007), this paper examining whether abandoning the IFRS affects private firms' financial reporting quality will contribute to the current literature.

Research setting. The U.K. accounting regulator (namely, the FRC) claimed that the new U.K. GAAP is designed to be more aligned to the IFRS in accounting treatments (compared to the old U.K. GAAP) and to improve the financial reporting quality with reduced disclosures (FRC 2014; PwC 2013). If the FRC does design the new U.K. GAAP well to achieve its goals, the decision to switch from the IFRS to the new U.K. GAAP should not have major influence on earnings quality. This is more likely to be true if the switch is mainly driven by the incentives to simply enjoy the reduced disclosures and costs under the new U.K. GAAP, rather than driven by the incentives to manage earnings. However, small differences in earnings quality between new U.K. GAAP adopters⁴ and persistent IFRS users may exist, as certain regulations under the new U.K. GAAP and the IFRS are still different. For example, compared to the situation in the IFRS, fair value is not so widely used in FRS 102. This can be seen in the treatment of financial assets (or, specifically, in terms of the "items of income, expense, gains or losses, and changes in fair value") that (earlier versions

⁴ Please note that this paper focuses on firms that voluntarily adopted the IFRS before, and the "new UK GAAP adopters" in this paper refer to firms that switched from the IFRS to the new U.K. GAAP, rather than all firms that adopted the new U.K. GAAP.

of) FRS 102 does not include the “financial instruments measured at fair value through other comprehensive income,” which are used under the IFRS (PwC 2015). Furthermore, when reporting “biological assets and its related agricultural produce,” companies could choose between the cost model and the fair value model under FRS 102. However, the IFRS only permits the use of the fair value model (PwC 2015). Hence, the choice between the new U.K. GAAP and the IFRS (implying different levels of using fair value) may affect the timely loss recognition because fair value, compared to cost, is argued to reflect companies’ situation in a timelier manner (Capkun and Collins 2018). Moreover, previous literature indicates that managers may use their discretion in fair value accounting to manage earnings (Dechow et al. 2010). Since the fair value model is relatively less used under FRS 102, the switch from the IFRS to the new U.K. GAAP may reduce the use of the fair value model, potentially reducing the opportunity for earnings management, which can result in higher earnings quality.

Additionally, companies do not need to amortize intangible assets with indefinite lives under the IFRS, whereas all intangible assets must be amortized under FRS 102 (PwC 2015). For example, goodwill is not amortized under the IFRS, but is amortized under FRS 102. This will affect the amortization and, therefore, the reported income. The differences between these two standards (for example, in amortization and in recognizing the gains or losses related to financial assets, as mentioned above) affect the way income is reported and may further influence the level of income reported and income smoothing. Since firms can determine whether intangible assets have indefinite or definite lives under the IFRS, the IFRS provides managers with more flexibility in amortization than FRS 102. Moreover, companies can decide to capitalize or expense development costs and borrowing costs, which should be capitalized under the IFRS (PwC 2013). Managers’ discretion over amortization and capitalization of certain costs could affect the level of discretionary accruals and, hence, the accruals quality (D’Souza, Jacob, and Ramesh 2000).

Hypothesis. As shown above, different incentives (manage earnings versus simply enjoy the reduced disclosure) will lead to different results in earnings quality after the switch from the IFRS to the new U.K. GAAP. Empirical findings about the impact of using the IFRS on earnings quality are contradictory (Brüggenmann et al. 2013; Soderstrom and Sun 2007), and none of existing literature explores the impact of the IFRS for SMEs on earnings quality. Furthermore, the discussion of research setting indicates that whether or not the switch to the new U.K. GAAP affects earnings quality will depend on how well the new U.K. GAAP is designed to achieve the FRC’s goals and the difference between the new U.K. GAAP and the IFRS. Hence, we do not make a definite prediction about how the switch to the new U.K. GAAP affects firms’ earnings quality. In this study, we develop and examine the following hypotheses.

H1: The switch from the IFRS to the new U.K. GAAP does not affect private firms’ earnings quality.

H2: The switch from the IFRS to the new U.K. GAAP affects private firms’ earnings quality.

III. RESEARCH METHOD

Sample and Data

The data on U.K. private firms were collected from the FAME database. The main analysis will examine whether the decision to switch from the IFRS to the new U.K. GAAP in 2015⁵ (that is, the firms that switched to the new U.K. GAAP immediately) is associated with earnings management. Moreover, we will further analyze this, using panel data from 2015–2018.⁶ This design is because firms that instantly switched to the new U.K. GAAP may have stronger incentives to do so, and the incentives behind the adoption would affect the subsequent earnings quality (Christensen et al. 2015).

We focus on private firms that voluntarily adopted the IFRS and investigate whether their choice between continuing using the IFRS and adopting the new U.K. GAAP affects their earnings quality. Hence, IFRS-IFRS firms (namely, persistent IFRS users) and IFRS-new U.K. GAAP firms (namely, new U.K. GAAP adopters) are included in our sample. After excluding firms without information needed for analyses and firms that did not use the IFRS before, the sample (total observations: 1,257) used for the main analysis consists of 268 IFRS-new U.K. GAAP firm observations and 989 IFRS-IFRS firm observations. The sample selection process can be found in Table 1.

⁵ Although the new U.K. GAAP can be adopted early from 2012, both the old and the new U.K. GAAP would be shown in the database as “U.K. GAAP.” Hence, it is not possible to tell whether the old or the new U.K. GAAP was used during 2012–2014. This is a limitation of this study. Accordingly, we use the data in 2015 to capture the impact in the first year when the new U.K. GAAP completely replaced the old U.K. GAAP (De George, Ferguson, and Spear 2012).

⁶ In 2019, there were several key changes in Brexit arrangements, including extensions of the Brexit date (Heald and Wright 2019). This resulted in high uncertainties in markets. Hence, the sample period ends in 2018 to eliminate the impact of Brexit on financial reporting quality.

TABLE 1
Sample

Sample Selection	IFRS→New U.K. GAAP	IFRS→IFRS	Total
U.K. private firms from the <i>FAME</i> database			129,495
Less: missing accounting standards data			(14,197)
Less: firms that used U.K. GAAP in both 2014 and 2015			(103,659)
Less: firms that used U.K. GAAP in 2014 but adopt IFRS in 2015			(6,033)
Preliminary sample	1,721	3,885	5,606
Less: financial firms (SIC 6000–6999)	(610)	(1,457)	(2,067)
Less: missing financial data	(843)	(1,439)	(2,282)
Final sample	268	989	1,257

This main analysis includes observations from both consolidated financial statements and individual financial statements. Robust tests will be conducted to examine whether results will be different when considering different types of financial statements. Moreover, we will use the propensity score matching method to control the potential endogeneity associated with accounting choices.

Measures of Earnings Quality and Empirical Models

Building on prior research in this area (Ahmed et al. 2013; Fiechter et al. 2018), this study uses the DiD model to examine whether this accounting choice has an impact on companies' earnings quality (Table 4). Following the studies of Cameran et al. (2014) and Dechow et al. (1995), we mainly examine earnings quality from two aspects: accruals (abnormal working capital and discretionary accruals) and timely loss recognition.

Abnormal Working Capital Accrual Model

In one of the few studies on private firms' choices over accounting standards, Cameran et al. (2014) use abnormal working capital accruals (AWCA) to measure earnings management associated with IFRS adoption. This paper follows DeFond and Park (2001) and Cameran et al. (2014) to examine the relationship between the switch to the new U.K. GAAP and AWCA.

$$AWCA'_t = WC_t - (WC_{t-1}/S_{t-1}) \times S_t \quad (1)$$

The calculation of *AWCA* is shown in Equation (1), where *WC* refers to non-cash working capital accruals and equals “(current assets – cash and short-term investments) – (current liabilities – short-term debt)”; and *S* is annual sales. The *AWCA_{it}* used in the DiD analysis is defined as the absolute value of abnormal working capital accrual over beginning total assets. This paper takes the view that a higher level of *AWCA* suggests a higher level of earnings management and, therefore, a lower earnings quality (Barth et al. 2008).

Discretionary Accruals

A significant amount of literature discussing public companies uses discretionary accruals to estimate the level of earnings management (Dechow et al. 1995; Healy and Wahlen 1999; McNichols 2000). To confirm the robustness of results, this paper applies a widely used modified Jones model (Dechow et al. 1995) to estimate discretionary accruals.

Following the research of Dechow et al. (1995), this paper estimates the modified Jones model as follows (Equations (2)–(4)). First, Equation (2) considers total accruals (TACC), which is the income before extraordinary items minus operating cash flows and is used to estimate the coefficients of independent variables to determine the normal level of accruals (NDACC) in Equation (3). Additionally, discretionary accruals (DACC) equal total accruals (Equation (2)) minus normal accruals (Equation (3)), as shown in Equation (4).

$$TACC_{it} = \alpha_1(1/TA_{it-1}) + \alpha_2((\Delta SALE_{it} - \Delta REC_{it})/TA_{it-1}) + \alpha_3(PPE_{it}/TA_{it-1}) + \varepsilon_i \quad (2)$$

$$NDACC_{it} = a_1(1/TA_{it-1}) + a_2((\Delta SALE_{it} - \Delta REC_{it})/TA_{it-1}) + a_3(PPE_{it}/TA_{it-1}) \quad (3)$$

$$DACC_{it} = TACC_{it} - NDACC_{it} \quad (4)$$

in which TA is the amount of total assets; $\Delta SALE_{it}$ equals annual change in sales; ΔREC_{it} equals annual change in accounts receivable from operating activities; and PPE_{it} equals gross property, plant, and equipment. The absolute value of discretionary accruals divided by beginning total assets is used in the DiD analysis and is shown as $|DACC_{it}|$. A higher level of $DACC$ is regarded in this paper as a higher level of earnings management and, hence, a lower earnings quality (Barth et al. 2008).

Timely Loss Recognition Method

In addition to evaluating earnings quality through accruals, this paper examines the timeliness with which companies report net loss, which studies have previously investigated (Ball and Shivakumar 2005; Basu 1997). If a firm reports its loss in a timely manner, it is regarded as having a better quality of earnings. This paper follows Ball and Shivakumar (2005) and Cameran et al. (2014) to measure timely loss recognition, and the model is as follows:

$$ACC_{it} = \alpha + \beta_1 DCFO_{it} + \beta_2 CFO_{it} + \beta_3 DCFO_{it} CFO_{it} + \beta_i IND_t + \varepsilon_{it} \quad (5)$$

in which ACC_{it} equals operating profit minus cash flow from operations (CFO) divided by beginning total assets; $DCFO_{it}$ equals 1 if CFO is negative, and 0 otherwise; CFO_{it} equals cash flow from operations, scaled by beginning total assets; and IND_t is the dummy variable used to control the industry effect.

IV. RESULTS

Descriptive Statistics

Table 2 reports summary statistics of variables for 2015. All continuous variables are Winsorized at the 1st and 99th percentiles. In the sample of firms that adopted the IFRS in 2014, 21 percent of firms turned away from the IFRS and adopted the new U.K. GAAP in 2015 (that is, new U.K. GAAP adopters). Table 2 also shows that new U.K. GAAP adopters generally have a higher sales growth rate, whereas persistent IFRS users tend to be larger and have a Big 4 auditor—common firm characteristics in IFRS users (Bassemir 2018; Francis, Khurana, Martin, and Pereira 2008). Furthermore, the accruals quality (measured by $AWCA$ and $|DACC|$) of new U.K. GAAP adopters and persistent IFRS users is not significantly different.

Table 3 reports the correlation matrix. The correlation between $AWCA$ (or $|DACC|$) and $UKGAAP$ is low, suggesting that switching from the IFRS to the new U.K. GAAP may not be associated with the accruals-based earnings management.

DiD Results

Switch from the IFRS to the New U.K. GAAP and Abnormal Accruals

We follow DeFond and Park (2001) and Cameran et al. (2014) in measuring abnormal accruals to examine whether the switch from the IFRS to the new U.K. GAAP affects earnings quality. The DiD analysis of $AWCA$ (see Table 4) confirms that the decision to switch from the IFRS to the new U.K. GAAP does not significantly affect companies' accruals quality. Since previous literature indicates that the choice of financial reporting standards could be used to manage earnings (Capkun et al. 2016), this result implies that managing accruals may not be the main reason for private firms to switch to the new U.K. GAAP. Instead, the results suggest that the switch is more likely to be driven by the reduced disclosures under the new U.K. GAAP and can be explained by rational choice theory (Bassemir 2018; PwC 2013; Scott 2000). The results, showing that under the new U.K. GAAP, these firms can still apply high-quality standards, while enjoying the benefits of fewer disclosures, support the FRC's purpose of introducing this new standard.

Switch from the IFRS to the New U.K. GAAP and Discretionary Accruals

This section applies another model, the modified Jones model (Dechow et al. 1995), to determine whether the switch from the IFRS to the new U.K. GAAP in private U.K. firms affects accruals quality through measuring discretionary accruals (DACC). As shown in Table 4, the choice between adopting the U.K. GAAP and continuously using the IFRS does not affect the level of accruals management. This result is consistent with that for estimating abnormal working capital accruals in the previous section and suggests that there is not sufficient evidence to reject H1. This finding again suggests that the FRC may achieve its goals of introducing the new U.K. GAAP well (PwC 2013), and a reduced IFRS

TABLE 2
Descriptive Statistics for 2015

Variables	Full Sample					New U.K. GAAP Adopters (n = 268)		IFRS Users (n = 989)		t-statistic	
	n	Mean	Median	Std. Dev.	Quartile 1	Quartile 3	Mean	Std. Dev.	Mean		Std. Dev.
<i>AWCA</i>	1,257	0.161	0.070	0.269	0.024	0.179	0.181	0.289	0.156	0.264	-1.309
<i>DACC</i>	1,257	0.273	0.094	0.371	0.027	0.304	0.270	0.355	0.274	0.376	0.145
<i>ACC</i>	1,257	-0.030	-0.026	0.286	-0.104	0.049	-0.019	0.297	-0.033	0.283	-0.657
<i>UKGAAP</i>	1,257	0.213	0.000	0.410	0.000	0.000	—	—	—	—	—
<i>LEV</i>	1,257	0.860	0.683	0.802	0.416	0.984	0.918	0.792	0.845	0.804	-1.326
<i>CFO</i>	1,257	0.068	0.066	0.231	-0.000	0.151	0.053	0.249	0.072	0.226	1.139
<i>ROA</i>	1,257	0.041	0.049	0.222	-0.009	0.128	0.031	0.255	0.044	0.212	0.748
<i>GROWTH</i>	1,257	0.080	0.020	0.454	-0.089	0.138	0.145	0.595	0.063	0.406	-2.139**
<i>DISSUE</i>	1,257	0.126	0.010	0.571	-0.126	0.195	0.146	0.584	0.120	0.568	-0.647
<i>BVD</i>	1,257	0.914	1.000	0.280	1.000	1.000	0.910	0.286	0.915	0.279	0.236
<i>SIZE</i>	1,257	10.380	10.207	2.055	8.844	11.722	10.158	1.988	10.440	2.070	2.038**
<i>BIG4</i>	1,257	0.667	1.000	0.472	0.000	1.000	0.616	0.487	0.680	0.467	1.949*

*, **, *** Indicate that a coefficient is statistically significant at the 10 percent, 5 percent, and 1 percent levels, respectively. See Appendix A for variable definitions.

TABLE 3
Correlation Matrix (Pearson Below and Spearman Above the Diagonal)

	<i>AWCA</i>	<i> DACC </i>	<i>ACC</i>	<i>UKGAAP</i>	<i>LEV</i>	<i>CFO</i>	<i>ROA</i>	<i>GROWTH</i>	<i>DISSUE</i>	<i>BVD</i>	<i>SIZE</i>	<i>BIG4</i>
<i>AWCA</i>	1	0.191***	0.091***	0.055*	0.143***	-0.049*	0.092***	0.112***	0.129***	0.093***	-0.277***	-0.056**
<i> DACC </i>	0.127***	1	0.052*	0.014	0.002	-0.055*	0.046	0.008	0.018	0.003	-0.281***	-0.107***
<i>ACC</i>	0.021	0.032	1	-0.008	-0.133***	-0.490***	0.431***	0.092***	-0.135***	0.036	-0.031	0.011
<i>UKGAAP</i>	0.039	-0.004	0.019	1	0.054*	-0.052*	-0.048*	0.036	0.024	-0.007	-0.056**	-0.056**
<i>LEV</i>	0.284***	0.057**	-0.157***	0.037	1	-0.040	-0.178***	0.226***	0.422***	0.009	0.043	-0.010
<i>CFO</i>	-0.057**	-0.035	-0.514***	-0.034	-0.083***	1	0.435***	0.054*	0.063**	0.019	0.003	-0.031
<i>ROA</i>	0.028	0.018	0.404***	-0.024	-0.217***	0.519***	1	0.180***	-0.034	0.054*	-0.066**	-0.009
<i>GROWTH</i>	0.359***	0.011	0.089***	0.075***	0.206***	-0.048*	0.051*	1	0.331***	-0.045	-0.012	-0.052*
<i>DISSUE</i>	0.309***	0.068**	-0.178***	0.019	0.377***	0.062**	-0.059**	0.257***	1	-0.011	0.045	-0.006
<i>BVD</i>	0.078***	0.001	0.008	-0.007	0.009	0.035	0.059**	-0.026	-0.002	1	-0.027	0.090***
<i>SIZE</i>	-0.172***	-0.238***	0.002	-0.056**	-0.098***	0.024	0.009	-0.016	-0.002	-0.020	1	0.377***
<i>BIG4</i>	-0.021	-0.115***	0.040	-0.056**	-0.022	-0.034	0.003	-0.019	0.026	0.090***	0.367***	1

*, **, *** Indicate that a coefficient is statistically significant at the 10 percent, 5 percent, and 1 percent levels, respectively. See Appendix A for variable definitions.

TABLE 4
Results of DiD Analysis on Earnings Quality between New U.K. GAAP Adopters and IFRS Users

	Pre(2014)			Post(2015)			Difference-in-Differences (Post – Pre)
	New U.K. GAAP Adopters (n = 268)	IFRS Users (n = 989)	IFRS-GAAP	New U.K. GAAP Adopters (n = 268)	IFRS Users (n = 989)	IFRS-GAAP	
Accruals							
<i>AWCA</i>	0.355	0.324	–0.031	0.181	0.156	–0.025	0.006
<i>DACC</i>	0.291	0.282	–0.009	0.270	0.274	0.004	0.013
Timely loss recognition							
<i>DCFO</i> × <i>CFO</i>	0.419	0.215	–0.204**	–0.346	0.239	0.585***	0.789*
Income smoothing							
σNI^*	8.496	6.666	–1.830*	6.190	4.916	–1.274**	0.556**
$\sigma NI^*/\sigma CFO^*$	1.449	1.383	–0.066***	1.565	1.363	–0.202***	–0.136***

*, **, *** Indicate that a coefficient is statistically significant at the 10 percent, 5 percent, and 1 percent levels, respectively. See [Appendix A](#) for variable definitions.

framework (such as the new U.K. GAAP or the IFRS for SMEs) may be helpful for accounting regulators to enhance the quality and consistency of financial reporting, in a more cost-effective way ([Gassen 2017](#)).

Switch from the IFRS to the New U.K. GAAP and Timely Loss Recognition

This section analyzes earnings quality from the perspective of timely loss recognition. [Table 4](#) (the interaction term of *DCFO* and *CFO*) shows a significant difference in timely loss recognition between firms that switch from the IFRS to the new U.K. GAAP and persistent IFRS users. The result suggests that the transition from the IFRS to the new U.K. GAAP significantly reduces the timely loss recognition. The different levels of using fair value and cost methods in the new U.K. GAAP and the IFRS (or the different disclosure levels required by the new U.K. GAAP and the IFRS) may explain this result ([Capkun and Collins 2018](#); [PwC 2015](#)). This result is consistent with prior literature ([Barth et al. 2008](#)) and indicates that we should reject H1. The result shows that although the new U.K. GAAP is designed to be closely aligned to the IFRS and the IFRS for SMEs, the differences between various standards still matter. Hence, users of financial reports, such as lenders, should be aware of these changes.

Further Discussion

Propensity Score Matching

Applying the propensity score matching method, this section examines whether the above results still hold, in the 1:1 (observations: 522), 1:2 (observations: 768), and 1:3 (observations: 979) matched samples. In all matched samples (untabulated results), we find no systematic differences in accruals quality (measured by *AWCA* and *DACC*) between new U.K. GAAP adopters and persistent IFRS users. Moreover, consistent with the finding in the previous subsection, we find, in all matched samples, that persistent IFRS users recognize losses in a more timely manner than those using the new U.K. GAAP. Overall, the results using propensity score matched samples are not significantly different from our main findings shown in [Table 4](#).

Consolidated and Individual Financial Statements

This section further analyzes whether results might differ for consolidated and individual financial statements. In our full sample (total observations: 1,257), 66 firms do not have the information about the type of financial statements. Hence, this section uses a subsample of 1,191 firms, among which 368 observations are about consolidated financial statements and 823 observations are about individual financial statements. Untabulated results show that for both consolidated and individual financial statements, U.K. private firms' choices (between the new U.K. GAAP and the IFRS) do not significantly influence their accruals quality (measured by *AWCA* and *DACC*). These results are consistent with our main findings. In addition, similar to our earlier finding, private firms using the IFRS for their individual accounts demonstrate more timely loss recognition than new U.K. GAAP adopters. However, private firms using the

IFRS for their consolidated accounts are not significantly different from new U.K. GAAP adopters in terms of timely loss recognition.

Switch from the IFRS to the New U.K. GAAP and Income Smoothing

To further understand the difference in earnings quality of new U.K. GAAP adopters and persistent IFRS users, this study follows prior the research (Barth et al. 2008; Cameran et al. 2014; Lang, Raedy, and Wilson 2006; Tarca 2004) to investigate income smoothing using two proxies. First, this study examines the variability of net income (ΔNI). A low variability suggests earnings smoothing and, thus, a lower earnings quality.

Second, this study measures variability of net income (ΔNI) relative to that of operating cash flows (ΔCFO). When operating cash flows change, net income subsequently changes. If the change in net income is relatively small compared to the change in operating cash flows, this may imply that companies smooth their income.

We first run Regressions (6) and (7) separately for the new U.K. GAAP adopters and persistent IFRS users to obtain the residuals, which can be regarded as abnormal variability in net income and operating cash flows and whose standard deviations (that is, $\sigma \Delta NI^*$ and $\sigma \Delta CFO^*$) will be used as the measurement of income smoothing.

$$\begin{aligned} \Delta NI_{it} = & \alpha + \beta_1 SIZE_{it} + \beta_2 GROWTH_{it} + \beta_3 LEV_{it} + \beta_4 EISSUE_{it} + \beta_5 DISSUE_{it} \\ & + \beta_6 TURN_{it} + \beta_7 CFO_{it} + \beta_8 BIG4_{it} + \beta_i IND_t + \varepsilon_{it} \end{aligned} \quad (6)$$

$$\begin{aligned} \Delta CFO_{it} = & \alpha + \beta_1 SIZE_{it} + \beta_2 GROWTH_{it} + \beta_3 LEV_{it} + \beta_4 EISSUE_{it} + \beta_5 DISSUE_{it} \\ & + \beta_6 TURN_{it} + \beta_7 CFO_{it} + \beta_8 BIG4_{it} + \beta_i IND_t + \varepsilon_{it} \end{aligned} \quad (7)$$

in which ΔNI equals annual change in net income; and ΔCFO equals annual change in cash flow from operations. Furthermore, $SIZE_{it}$ is the natural logarithm of total assets; $GROWTH_{it}$ is annual sales growth rate; LEV_{it} is total liability divided by beginning total assets; $EISSUE_{it}$ equals annual change rate of shareholder's equity; $DISSUE_{it}$ equals annual change rate of total liabilities; $TURN_{it}$ equals sales over beginning total assets; and $BIG4_{it}$ equals 1 if a firm has a Big 4 auditor (that is, Deloitte, Ernst & Young, KPMG, or PwC), and 0 otherwise.

The DiD results (shown in Table 4) about the impact of switching accounting standards on income smoothing are inconclusive due to the inconsistent results obtained using the above two proxies ($\sigma \Delta NI^*$ and $\sigma \Delta NI^*/\sigma \Delta CFO^*$). This finding suggests that turning away from IFRS and adopting new U.K. GAAP, which is consistent with IFRS and IFRS for SMEs, may not necessarily reduce firms' earnings quality.

Control for the Endogeneity

Following previous literature (Adut, Holder, and Robin 2013), we use the Heckman model (Heckman 1979) to control for the endogeneity problem associated with the choice between the new U.K. GAAP and the IFRS. The first stage of the Heckman model examines the factors affecting companies' choice of accounting standards, as presented in Regression (8). We then examine Regressions (9) and (10) below to investigate the relationship between the choice of accounting standards and earnings quality, through the Heckman model.

$$\begin{aligned} UKGAAP_{it} = & \alpha + \beta_1 LEV_{it} + \beta_2 ROA_{it} + \beta_3 GROWTH_{it} + \beta_4 SIZE_{it} + \beta_5 BIG4_{it} + \beta_6 D_S_{it} \\ & + \beta_7 F_S_{it} + \beta_8 BVD_{it} + \beta_i IND_t + \varepsilon_{it} \end{aligned} \quad (8)$$

$$\begin{aligned} AWCA_{it} = & \alpha + \beta_1 UKGAAP_{it} + \beta_2 LEV_{it} + \beta_3 CFO_{it} + \beta_4 ROA_{it} + \beta_5 GROWTH_{it} \\ & + \beta_6 DISSUE_{it} + \beta_7 BVD_{it} + \beta_8 SIZE_{it} + \beta_9 BIG4_{it} + \beta_i IND_t + \varepsilon_{it} \end{aligned} \quad (9)$$

$$\begin{aligned} |DACC_{it}| = & \gamma_0 + \gamma_1 UKGAAP_{it} + \gamma_2 LEV_{it} + \gamma_3 CFO_{it} + \gamma_4 ROA_{it} + \gamma_5 GROWTH_{it} \\ & + \gamma_6 DISSUE_{it} + \gamma_7 BVD_{it} + \gamma_8 SIZE_{it} + \gamma_9 BIG4_{it} + \gamma_i IND_t + \varepsilon_{it} \end{aligned} \quad (10)$$

in which $UKGAAP_{it}$ equals 1 if a firm switches from IFRS to the new U.K. GAAP in 2015, and 0 otherwise; ROA_{it} is operating profit divided by beginning total assets; D_S_{it} equals 1 if a director is also a shareholder, and 0 otherwise; F_S_{it} equals 1 if a firm has foreign shareholders, and 0 otherwise; and BVD_{it} equals 1 if the firm has a major shareholder, and 0 otherwise.

As shown in Table 5, Panel B, the coefficient of inverse Mills ratio (*IMR*) is not significant, and, unsurprisingly, the regression result with Heckman correction is not materially different from that without correction (in Table 5, Panel A). The result also implies that the earnings quality (measured by abnormal working capital accruals, *AWCA*, here) of new U.K. GAAP adopters is not systematically different from that of persistent IFRS users.

We further analyze whether the switch from the IFRS to the new U.K. GAAP is associated with earnings quality (in terms of discretionary accruals, *DACC*) and use the Heckman model to control for the endogeneity. This result (see Table 6) is consistent with that for estimating *AWCA* (in Table 5) and suggests that the choice between the U.K. GAAP and the IFRS does not significantly affect firms' earnings quality. Overall, the results in this section are consistent with the DiD analyses shown earlier.

TABLE 5

Results of Regressions on Measures of Abnormal Accruals

Panel A: Regression Results (without Heckman Correction)

	<i>AWCA_{it}</i>
<i>UKGAAP</i>	0.002 (0.14)
<i>LEV</i>	0.052*** (5.62)
<i>CFO</i>	-0.118*** (-3.44)
<i>ROA</i>	0.134*** (3.68)
<i>GROWTH</i>	0.156*** (10.06)
<i>DISSUE</i>	0.093*** (7.22)
<i>BVD</i>	0.075*** (3.14)
<i>SIZE</i>	-0.021*** (-5.93)
<i>BIG4</i>	0.016 (1.02)
Intercept	0.201*** (4.23)
Industry fixed effects	Yes
n	1,257
Adjusted R ²	0.242
F	24.55 (p < 0.001)

Panel B: Regression Results with Heckman Correction

	<i>AWCA_{it}</i>
<i>UKGAAP</i>	0.096 (0.47)
<i>IMR</i>	-0.054 (-0.46)
Control variables	Yes
Industry fixed effects	Yes
n	1,257

*, **, *** Indicate that a coefficient is statistically significant at the 10 percent, 5 percent, and 1 percent levels, respectively. t-statistics are presented in parentheses.

IMR is the inverse Mills ratio obtained using the Heckman model and firm characteristics model, namely, Regression (1). See Appendix A for variable definitions.

TABLE 6
Results of Regressions on Measures of Discretionary Accruals

Panel A: Regression Results (without Heckman correction)

	(1) $ DACC_{it} $	(2) $+DACC_{it}$	(3) $-DACC_{it}$
<i>UKGAAP</i>	-0.026 (-1.07)	0.009 (1.09)	0.059 (1.57)
<i>LEV</i>	0.014 (1.03)	-0.006 (-1.05)	-0.009 (-0.43)
<i>CFO</i>	-0.105** (-2.04)	-0.486*** (-21.39)	0.292*** (3.72)
<i>ROA</i>	0.112** (2.05)	0.538*** (23.60)	-0.315*** (-3.65)
<i>GROWTH</i>	-0.011 (-0.45)	0.005 (0.61)	0.023 (0.62)
<i>DISSUE</i>	0.047** (2.40)	0.009 (1.23)	-0.055** (-1.97)
<i>BVD</i>	-0.016 (-0.45)	0.002 (0.14)	0.024 (0.44)
<i>SIZE</i>	-0.042*** (-7.87)	-0.002 (-1.31)	0.053*** (6.33)
<i>BIG4</i>	-0.033 (-1.42)	-0.000 (-0.05)	0.072** (2.06)
Intercept	0.719*** (10.07)	0.074*** (2.90)	-0.994*** (-9.06)
Industry fixed effects	Yes	Yes	Yes
n	1,257	541	716
Adjusted R ²	0.102	0.613	0.145
F	9.37 (p < 0.001)	51.23 (p < 0.001)	8.12 (p < 0.001)

Panel B: Regression Results with Heckman Correction

	(1) $ DACC_{it} $	(2) $+DACC_{it}$	(3) $-DACC_{it}$
<i>UKGAAP</i>	-0.188 (-0.61)	0.110 (0.96)	0.328 (0.89)
<i>IMR</i>	0.093 (0.53)	-0.058 (-0.88)	-0.156 (-0.73)
Control variables	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes
n	1,257	541	716

*, **, *** Indicate that a coefficient is statistically significant at the 10 percent, 5 percent, and 1 percent levels, respectively. t-statistics are presented in parentheses.

IMR is the inverse Mills ratio obtained using the Heckman model and firm characteristics model, namely, [Regression \(1\)](#). See [Appendix A](#) for variable definitions.

Testing Hypothesis Using Panel Data

This section uses panel data (from 2015 to 2018) to examine whether the decision to abandon the IFRS and adopt the new U.K. GAAP affects firms' earnings quality. We examine the 1:1 and 1:3 matched samples, obtained using the propensity score matching method. [Table 7](#) presents the results from the 1:3 matched sample. The DiD analyses show that the switch to the new U.K. GAAP does not significantly affect firms' accruals quality or how timely firms recognize their loss, but it reduces firms' income smoothing activities. The (untabulated) results from the 1:1 matched sample are

TABLE 7
Results of DiD Analysis on Earnings Quality between New U.K. GAAP Adopters and IFRS Users (2015–2018; 1:3 Matched Sample)

	Pre			Post			Difference-in-Differences (Post – Pre)
	NEW U.K. GAAP Adopters (n = 875)	IFRS Users (n = 2,979)	IFRS-GAAP	NEW U.K. GAAP Adopters (n = 875)	IFRS Users (n = 2,979)	IFRS-GAAP	
Accruals							
<i>AWCA</i>	0.8279	0.7819	-0.0460	0.6504	0.6497	-0.0007	0.0453
$ DACC $	0.3260	0.3200	-0.0060	0.3013	0.2876	-0.0137	-0.0077
Timely loss recognition							
<i>DCFO</i> × <i>CFO</i>	0.3392	0.2530	-0.0862	0.0255	0.2569	0.2314***	0.3177
Income smoothing							
σNI^*	5.6741	5.4487	-0.2254	5.6577	5.4494	-0.2083	0.0172
$\sigma NI^*/\sigma CFO^*$	0.9065	0.7971	-0.1094***	0.9789	0.7858	-0.1930***	-0.0837***

*, **, *** Indicate that a coefficient is statistically significant at the 10 percent, 5 percent, and 1 percent levels, respectively. See Appendix A for variable definitions.

consistent with those presented in Table 7. Overall, the results here are consistent with our main findings (derived from the 2015 data) that the switch from the IFRS to the new U.K. GAAP does not significantly affect the accruals quality, but has some impact on income smoothing. The results again suggest that the switch from the IFRS to the new U.K. GAAP is more likely to be driven by the cost-benefit analysis rather than agency problem (PwC 2013; Scott 2000). The results also show that a reduced IFRS framework could be helpful for accounting regulators to obtain the consistency and high quality of financial reporting, with lower costs (Gassen 2017), but the differences between the IFRS and its reduced forms should still be noted.

V. CONCLUSIONS

This paper examines whether the switch from the IFRS to the new U.K. GAAP is associated with the earnings quality of U.K. private firms. We first investigate the abnormal working capital accruals and discretionary accruals of the new U.K. GAAP adopters and persistent IFRS users. The results show that the switch from the IFRS to the new U.K. GAAP does not have a significant impact on accruals quality. Additionally, this paper shows weak evidence that the new U.K. GAAP adopters recognize losses in a less timely manner than those using the IFRS, after switching to the new U.K. GAAP in 2015. This implies that although the new U.K. GAAP is more aligned to the IFRS in accounting treatments compared to the old U.K. GAAP, the persistence of the old U.K. GAAP in the new U.K. GAAP (such as the less use of fair value) still makes a difference (PwC 2015). Further DiD tests do not find conclusive results on how the switch to the new U.K. GAAP may affect companies' income smoothing activities.

In general, our results suggest that the switch from the IFRS to the new U.K. GAAP does not significantly affect the accruals quality of companies, but has some impact on timely loss recognition and income smoothing. These findings suggest that overall earnings quality under the new U.K. GAAP is comparable to that under the IFRS. Since the IFRS is often regarded as high-quality, the results support the FRC's decision to introduce the new U.K. GAAP, which aims to be high-quality financial reporting standards, when considering the nature and size of different businesses (PwC 2013). Our results also suggest that U.K. private firms' decision to switch from the IFRS to the new U.K. GAAP is mainly driven by the benefit of reduced disclosure under the U.K. GAAP rather than earnings management and can be explained by rational choice theory (PwC 2013; Scott 2000). Because private firms are often controlled by major shareholders and are less dependent on public disclosure to reduce information asymmetry (Beatty and Harris 1999), the new U.K. GAAP, which is designed to be closely align to the IFRS in accounting treatments, but requires less disclosure than the IFRS, may be attractive for private firms that adopted the IFRS before (Ernst & Young 2013; KPMG 2015). Since the switch from the IFRS to the new U.K. GAAP is not associated with lower earnings quality, a reduced IFRS framework may be helpful to tackle the high cost associated with the IFRS (Bassemir 2018; Gassen 2017). However, users of financial reports and regulators should still be aware of the potential consequences (such as changes in how timely firms recognize their loss) following the change of accounting standards. Managers should also be aware of the differences between the new U.K. GAAP and the IFRS and the subsequent implications on earnings quality when making decisions over accounting standards. The findings are helpful for other private firms,⁷ SMEs, and regulators in evaluating the adoption of the new U.K. GAAP (or similar standards like the IFRS for SMEs). Our results should also be relevant to public firms in countries where the IFRS is not yet fully adopted (such as the U.S. and China).

This is the first study discussing whether turning away from the IFRS and adopting the new U.K. GAAP influences firms' earnings quality, and the results help to evaluate whether the FRC's goal (namely, improving earnings quality while reducing the extensive disclosures required by the IFRS) is achieved through introducing the new U.K. GAAP. This issue is very important, as the high compliance costs and extensive disclosures of the IFRS are often criticized. There is an ongoing discussion on whether the IFRS for SMEs can overcome the drawbacks of the IFRS. However, no existing literature investigates the impact of the IFRS for SMEs on firms' earnings quality, which is a key proxy for measuring the quality of an accounting standard. Through analyzing the impact of the new U.K. GAAP, which share similar ideas of the IFRS for SMEs, on earnings quality, our results help to inform accounting regulators about the potential consequences of using the new U.K. GAAP and similar standards. If a reduced IFRS framework (such as the

⁷ These would include private firms in other countries and other private firms (which do not switch from the IFRS to the new U.K. GAAP) in the U.K. As shown in Appendix B, the majority of U.K. private firms use the U.K. GAAP rather than the IFRS. Due to the data limitation, we are not able to directly investigate the impact of changing from the old U.K. GAAP to the new U.K. GAAP on earnings quality. However, our findings and the FRC's goal to introduce the new U.K. GAAP to improve financial reporting quality would still be relevant to the majority of private firms that used the U.K. GAAP rather than the IFRS. This is because from 2015, the new U.K. GAAP replaced the old U.K. GAAP, and these two standards have very different requirements in several aspects, implying that all private firms (including those changing from the old U.K. GAAP to the new U.K. GAAP) would face new accounting standards and may need to use different accounting methods and treatments following the introduction of the new U.K. GAAP. Therefore, whether or not the new U.K. GAAP are associated with high earnings quality would be relevant to all U.K. private firms.

new U.K. GAAP) can help to reduce disclosure level while maintaining the consistency with the IFRS and the quality of financial reporting, this may be the direction to go, particularly for firms (such as private firms) that do not heavily rely on public disclosure or do not have public accountability. Since the IFRS for SMEs is designed to maintain the consistency with the IFRS and to reduce the disclosure level required by the IFRS, and the design of the new U.K. GAAP also incorporates the IFRS for SMEs, this paper provides useful information for evaluating the use of the IFRS for SMEs by private firms. This paper also contributes to the growing area of research in private firms' financial reporting.

Future research could use data from other countries to investigate whether the adoption of the IFRS for SMEs or a localized reduced framework of IFRS, which share the same idea of the IFRS for SMEs, affects firms' earnings quality. Further work might also analyze whether the adoption of the new U.K. GAAP or the IFRS for SMEs has other impacts, such as on comparability of financial reporting, tax, or dividends.

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APPENDIX A

Variable Definitions

Variable Name	Definitions
<i>AWCA</i>	The absolute value of the abnormal working capital accruals scaled by beginning total assets.
$ DACC $	The absolute value of discretionary accruals scaled by beginning total assets.
<i>ACC</i>	Operating profit minus <i>CFO</i> , scaled by beginning total assets.
<i>UKGAAP</i>	Dummy variable that takes the value of 1 when a firm switches from the IFRS to the new U.K. GAAP and 0 if a firm's annual reports are still prepared in accordance with the IFRS.
<i>LEV</i>	Total liabilities scaled by beginning total assets.
<i>CFO</i>	Cash flow from operations scaled by beginning total assets.
<i>ROA</i>	Operating profit divided by beginning total assets.
<i>GROWTH</i>	Annual change in net sales.

(continued on next page)

APPENDIX A (continued)

Variable Name	Definitions
<i>EISSUE</i>	Annual change in shareholder's equity.
<i>DISSUE</i>	Annual change in total liabilities.
<i>BVD</i>	A dummy variable that equals 1 if the firm has a major shareholder, and 0 otherwise.
<i>SIZE</i>	Log of total assets.
<i>BIG4</i>	A dummy variable that equals 1 if the firm's auditor is Deloitte, Ernst & Young, KPMG, or PwC, and 0 otherwise.
<i>D_S</i>	A dummy variable that equals 1 if a director is also a shareholder, and 0 otherwise.
<i>F_S</i>	A dummy variable that equals 1 if the firm has foreign shareholders, and 0 otherwise.
<i>IND</i>	Industry dummy variables.
<i>DCFO</i>	Value of 1 if CFO is negative, and 0 otherwise.

APPENDIX B

Changes in Using Accounting Standards (for All Observations of U.K. Private Firms with Accounting Choice Data, during 2013–2015)

Panel A: Transition Matrices

Initial Status (%)		Transition Matrix 1 (%)		Intermediate Status (%)		Transition Matrix 2 (%)		Final Status (%)	
2013		2014		2014		2015		2015	
		IFRS	GAAP	IFRS	GAAP	IFRS	GAAP	IFRS	GAAP
IFRS	GAAP	2013 IFRS	84.07	15.93	2014 IFRS	69.30	30.70	2015 IFRS	8.60
4.23	95.77	2013 GAAP	1.36	98.64	2014 GAAP	5.50	94.50	2015 GAAP	91.40

Panel B: Distribution for Using Patterns of Accounting Standards

2013	2014	2015	Firm Observations	Percent
GAAP	GAAP	GAAP	103,296	89.59
GAAP	GAAP	IFRS	5,619	4.87
GAAP	IFRS	IFRS	852	0.74
GAAP	IFRS	GAAP	652	0.57
IFRS	IFRS	IFRS	3,033	2.63
IFRS	IFRS	GAAP	1,069	0.93
IFRS	GAAP	GAAP	363	0.31
IFRS	GAAP	IFRS	414	0.36
Total			115,298	100.00

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