



International Financial Reporting Standards and the quality of financial statement information

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ABSTRACT

This study focuses on the adoption of the International Financial Reporting Standards (IFRSs) in the UK and concentrates in the switch from the UK GAAP to IFRSs. The study seeks to determine whether IFRS adoption leads to higher quality accounting numbers. By examining company accounting measures reported under the UK GAAP and IFRSs, the study investigates the earnings management potential under IFRSs. The paper also studies the value relevance of IFRS-based financial statement information. The study indicates that the implementation of IFRSs generally reinforces accounting quality. The findings show that the implementation of IFRSs reduces the scope for earnings management, is related to more timely loss recognition and leads to more value relevant accounting measures. This suggests that less information asymmetry and earnings manipulation would lead to the disclosure of informative and higher quality accounting information and would therefore assist investors in making informed and unbiased judgements.

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1. Introduction

Agency theory makes a number of predictions regarding the behaviour of managers. It would suggest that by adopting IFRSs, firms act optimally and promote financial reporting quality and investor interests (see Fields, Lys & Vincent, 2001). For example, highly leveraged firms would be keen to adopt IFRSs in order to satisfy the needs of lenders and the requirements of debt covenants and/or avoid political attention and scrutiny (see Lambert, 2001). Healy (1985) suggests that the flexibility allowable in financial reporting may cause managers to behave opportunistically (see Burgstahler & Dichev, 1997; Weil, Fung, Graham & Fagotto, 2006). This would imply that managers might manage the reported earnings in order to demonstrate a favourable transition to IFRSs (DeFond & Park, 1997; Hand & Skantz, 1998; Fields et al., 2001) or to avoid adverse implications on their profit figures and debt-paying ability (Watson, Shrivs & Marston, 2002).

A crucial question is how the adoption of IFRSs would affect accounting quality. The fact that the UK is considered to be a common-law country with active stock and debt markets, a diverse base of investors, strong

investor protection mechanisms and investor-oriented financial reporting¹ (Tendeloo & Vanstraelen, 2005) might have benefited the transition process. Previous studies (Tarca, 2004; Barth et al., 2005; Lang et al., 2005; Tendeloo & Vanstraelen, 2005; Hung & Subramanyam, 2007) exhibit that IFRSs are information-oriented and improve the quality of financial reporting, thereby meeting the information needs of investors and reinforcing the structures of the stock market.

The study focuses on firms listed on the London Stock Exchange and determines whether the adoption of IFRSs has improved accounting quality. The implementation of IFRSs is compulsory for listed firms that belong to member states of the European Union (1606/2002/EC), the effective date being 1 January 2005.² The study is exploratory in nature and tests for systematic differences among UK firms in the light of IFRS adoption. The period under analysis is the official period of adoption, i.e. 2005, and the pre-official adoption period, i.e. 2004. The empirical investigation concentrates in the

¹ Unlike common-law countries, in code-law countries, the stock market is less active and accounting information is directed towards the needs of banks, financial institutions and the government (Ball et al., 2000; La Porta et al., 2000). This would tend to call for less public disclosure, and thus enhance the scope for earnings manipulation (Leuz et al., 2003), in order to protect their private benefits (Renders & Gaeremynck, 2007). Future research should examine the association between disclosure-enhancing IFRSs, earnings manipulation and weak investor protection regimes.

² Useful information on the role of the European Commission with respect to the adoption and implementation of IFRSs, the convergence of IFRSs and US GAAP, and the work of the IASB with national standard setters can be obtained from the CFA Institute at http://www.cfainstitute.org/centre/topics/reporting/reporting_standards.html.

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examination of the earnings management potential under IFRSs and the value relevance of IFRS-based accounting reports as compared to UK GAAP. The study shows that IFRS adoption reduces the scope for earnings management, leads to more timely loss recognition and to more value relevant accounting measures.

The motivation of the study relates to whether a particular accounting method/rule has a real impact, such that managerial decisions would need to be altered to minimise the adverse effects of the accounting change. The adverse impact of an accounting change could be mitigated by smoothing the accounting numbers and manipulating the accounting change to suit the financial decisions of the firm (see *Bazaz & Senteney, 2001*). Such information would be useful for the accounting standard setting process, particularly with regard to whether stricter or more flexible financial reporting should be imposed (see *Levitt, 1998*). There have been a number of studies about IFRS implementation in different national settings. For example, *Eccher and Healy (2003)* study IFRSs and the Chinese GAAP, while *Leuz (2003)* and *Hung and Subramanyam (2004)* study IFRSs and the German GAAP. The UK is a common-law country with strong investor protection mechanisms in place, while for example Germany and China are code-law countries. Hence, it would be fruitful to investigate the situation for such a setting and to identify the impact of IFRS adoption on accounting quality, taking into consideration that the UK GAAP is a common-law and investor-oriented system. The *Accounting Standards Board (2003)* has identified a number of differences between IFRSs and the UK GAAP, which are presented in *Appendix C*.

The remaining sections of the study are as follows. *Section 2* presents the theoretical background of the study. *Section 3* shows the research hypotheses. *Section 4* describes the datasets and the research structure of the study. *Section 5* discusses the empirical findings, and *Section 6* presents the conclusions and implications of the study.

2. Theoretical background

2.1. Contribution of IFRSs

IFRSs are issued by the International Accounting Standards Board (IASB), formerly known as International Accounting Standards Committee (IASC). The main objective of the IASB is “to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users make economic decisions” (*Epstein & Mirza, 2002*, p. 11).

The implementation of IFRSs would reduce the information asymmetry between informed and uninformed investors (*Bushman & Smith, 2001*). For example, IAS 1 ‘Presentation of Financial Statements’ requires sensitive information, such as managerial judgements and assumptions while forming the entity’s accounting policies as well as sources of estimation uncertainty that may have a material impact on the entity’s financial statements, to be appropriately disclosed and reported in the annual reports. The reduction of uncertainty and information asymmetry would smooth the communication between managers and other related interested parties, such as shareholders, lenders, regulatory and supervisory authorities, financial analysts, etc. This would therefore tend to reduce the related agency costs that might otherwise arise (*Bushman & Smith, 2001; Healy & Palepu, 2001*), and would in turn tend to lead to an appreciation in stock returns, which might be unrelated to firm current financial performance (*Gelb & Zarowin, 2002*). Lower information asymmetry would also lead to lower costs in issuing equity capital (*Glosten & Milgrom, 1985; Diamond & Verrecchia, 1991*) and debt (*Clarkson, Guedes & Thompson, 1996; Sengupta, 1998; Botosan & Plumlee, 2002*).

The benefits of the implementation of IFRSs include the harmonisation of accounting practice across adopting countries, which in turn leads to higher comparability, lower transaction costs and enhances international investment. IFRSs also assist investors in making informed financial decisions and predictions of firm future financial performance (*Street, Nichols & Gray, 2000*). The IASB includes over 140 accounting bodies, representing over 100 nations. The International Organization of Securities Commissions (IOSCO) has approved the use of IFRSs for cross-border stock exchange listings. Several major stock markets, such as London, Frankfurt, Zurich, Hong Kong, Amsterdam and Rome, accept the preparation of financial statements of foreign listed companies under IFRSs. Essentially, the adoption of IFRSs gives a positive signal of higher quality accounting and transparency (*Tendeloo & Vanstraelen, 2005*). In a similar vein, *Daske and Gebhardt (2006)* report that firms that voluntarily or mandatorily implement IFRSs tend to display higher disclosure quality than firms that use their national GAAP. *Leuz and Verrecchia (2000)* argue that the use of IFRSs would also lead to lower information asymmetry and cost of capital. Hence, it would be easier for firms implementing IFRSs to obtain debt and equity capital (*El-Gazzar, Finn & Jacob, 1999*). The provision of quality accounting disclosures would tend to reduce the opportunities for earnings manipulation and enhance the stock market efficiency (*Baiman & Verrecchia, 1996; Kasznik, 1999; Leuz, 2003*).

The higher disclosure requirements and financial reporting quality that stem from IFRSs implies that the adoption of IFRSs gives a positive signal to investors as information asymmetry and agency costs tend to diminish (*Tarca, 2004*). Other explanatory proxies of the adoption of IFRSs relate to high profitability, the issuance of equity or debt capital in the adoption period, debt covenants, the differences between domestic GAAP and IFRSs (*Holthausen, 1990; Sweeney, 1994; May, 1995; Ashbaugh, 2001; Cuijpers & Buijink, 2005*). The effects of IFRSs would tend to have a positive impact on adopters’ stock returns and other stock-related financial performance measures, stock option schemes, etc (*Matsunaga, 1995; Guidry, Leone & Rock, 1999; Chung, Firth & Kim, 2002*). The response of the stock market to the implementation of IFRSs would be associated with the contribution of IFRSs compared to the domestic GAAP. The potential costs of adopting IFRSs involve costs of transition from domestic GAAP to IFRSs and costs of compliance for firms and enforcement for regulatory authorities (*Carnachan, 2003*). Firms’ incentives to adopt IFRSs would also tend to be associated with compliance and non-compliance costs (*Ball, Kothari & Robin, 2000*).³

2.2. Managerial behaviour

Managerial behaviour is associated with contractual arrangements, such as compensation schemes and debt covenants as well as asset pricing, information asymmetry, agency and political costs (*Scott, 1997; Han & Wang, 1998; Francis, 2001; Lambert, 2001*). The preparation of financial statements often requires an exercise of judgement (*Jensen & Meckling, 1976; Fama, 1980*). This in association with the flexibility in financial reporting, which gives firms some leeway in the implementation of accounting regulation, may give rise

³ Given that the implementation of IFRSs is compulsory for listed firms (that operate within the EU), in certain cases where IFRS adoption proves to be burdensome, especially due to country-specific institutional and cultural differences (see *Ball, Robin & Wu, 2003*), and the costs of compliance exceed the costs of non-compliance, firms might consider exiting the market to escape using IFRSs and relieve their financial situation. A decision to exit the market should follow a total cost–benefit analysis taken from a long-run perspective and might apply for firms of small size and profitability. This falls outside the scope of the study and could be an object for future research. Future research should also focus on the comparison of compliance and transition costs between countries with weak and strong investor protection laws.

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