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An analysis of the effect of mandatory adoption of IAS/IFRS on earnings management

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ABSTRACT

This paper examines whether mandatory adoption of international accounting standards, IAS/IFRS, by French companies is associated with lower earnings management. In addition, the impact of six factors that may be related to earnings management level are also considered: the independence and the efficiency of the board of directors, the separation of roles of CEO and Chairman of the board, the existence of an independent audit committee, the existence of block shareholders, the quality of the external audit and the listing on foreign financial markets.

Based on a sample of 353 French listed groups relating to the period 2003–2006, our results show that the mandatory adoption of IAS/IFRS is associated with a reduction in the earnings management level. In addition, the independence and the efficiency of the board of directors, the existence of an independent audit committee, the existence of block shareholders, the quality of the external audit and the listing on foreign financial markets are important factors for enforcement of IAS/IFRS in France. Mandatory adoption of IAS/IFRS has decreased earnings management level for companies with good corporate governance and those that depend on foreign financial markets.

1. Introduction

On 19 July 2002, the European Parliament issued a regulation (1606/2002/EC) requiring all EU listed companies to prepare consolidated financial statements based on International Accounting Standards (IAS/IFRS) by 2005.

Our paper examines whether mandatory adoption of IAS/IFRS is associated with lower earnings management. In particular, we question whether mandatory adoption of IAS/IFRS in France, a code-law country, is sufficient to override managers' incentives to engage in earnings management. In fact, previous research provides evidence that earnings management magnitude is on average higher in code-law countries with low investor protection rights, compared to common-law countries with high investor protection rights (Leuz, Nanda, & Wysocki, 2003; Van Tendeloo & Vanstraelen, 2005).

Previous literature has concentrated mainly on the voluntary adoption effect of IAS/IFRS by German companies on earnings management (Barth, Landsman, & Lang, 2008; Van Tendeloo & Vanstraelen, 2005). However, there is little research examining the mandatory adoption effect of IAS/IFRS on earnings management in French companies. We concentrate on France because, in contrast to Germany, it is an IAS/IFRS first-time adopter. This allows us to avoid the sample selection bias of prior studies on voluntary adoption of IAS/IFRS. In addition, France is a code-law country, with low investor protection rights and high magnitude of earnings management (Leuz et al., 2003). Therefore, mandatory adoption of IAS/IFRS should

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have a significant impact on earnings management. Furthermore, by focusing on France, we study a country which has made a major change from the stakeholder-oriented French GAAP to the shareholder-oriented IAS/IFRS. In fact, regulatory changes in France have raised numerous questions concerning the potential effects of mandatory adoption of IAS/IFRS in an accounting environment that is unaccustomed to the utilization of accounting standards of Anglo-American inspiration. The accounting system in France is characterized by regulatory rigidity and a legalistic outlook and differs significantly from the international accounting system that is marked by a conceptual framework that safeguards shareholder interests.

The results of our study show that mandatory adoption of IAS/IFRS by French companies has decreased earnings management level. The results also show that the independence and effectiveness of the board of directors, the existence of an independent audit committee, the presence of block shareholders, the quality of the external audit and listing on foreign financial markets are important factors associated with enforcement of IAS/IFRS in France. Mandatory adoption of IAS/IFRS has decreased earnings management level for companies with good corporate governance and those that depend on foreign financial markets.

The remainder of this paper is organized as follows. Section 2 provides theoretical background and hypotheses for the study. The research design is presented in Section 3. The results are discussed in Section 4. Finally, in Section 5, we summarize our results, discuss the implications and limitations of our analysis and give suggestions for further research.

2. Theoretical background and hypotheses

2.1. Effect of mandatory adoption of international accounting standards (IAS/IFRS) on earnings management

A wide literature has addressed the issue of earnings management. Most research in this area has concentrated on the Anglo-American world. Fewer studies have focused on earnings-management in countries from the Euro-Continental accounting model.

Previous research provides evidence that earnings management magnitude is on average higher in code-law countries with low investor protection rights, compared to common-law countries with high investor protection rights (Daske, Gebhardt, & McLeay, 2006; Han, Kang, Salter, & Yoo, 2010; Leuz et al., 2003).

This paper examines whether mandatory adoption of IAS/IFRS in France, a code-law country, is sufficient to override managers' incentives to engage in earnings management.

Little research has examined the impact of voluntary adoption of international standards on earning management. Van Tendeloo and Vanstraelen (2005) find that voluntary adoption of IAS/IFRS cannot be associated with lower earnings management. However, Barth et al. (2008) and Christensen, Lee, and Walker (2008) found that voluntary adoption of IAS/IFRS is associated with lower earnings management.

In our study, we test the following hypothesis:

H1. Mandatory adoption of international accounting standards (IAS/IFRS) by French companies contributes to the reduction of earnings management.

Earnings management was measured in our research by discretionary accruals estimated by the Kothari, Leone, and Wasley (2005) model.

2.2. Enforcement factors of international accounting standards (IAS/IFRS)

Evidence supporting our first hypothesis could be attributed either to the high quality of IAS/IFRS or to the high enforcement of these standards. Indeed, the quality of financial statements prepared using IAS/IFRS depends on both the quality of these standards and their implementation (Van Tendeloo & Vanstraelen, 2005). Our research contributes to this debate by examining factors that have contributed to the enforcement of IAS/IFRS in France. Two categories of factors are examined: corporate governance factors and dependence on international markets.

2.2.1. Corporate governance factors

A wide literature has addressed the issue of the impact of corporate governance mechanisms on earnings management (Bédard, Chtourou, & Courteau, 2004; Bozec, 2008; Jaggi & Leung, 2007; Jiraporn & Gleason, 2007; Peasnell, Pope, & Young, 2005; Xie, Davidson, & Dadalt, 2003).

Corporate governance mechanisms are generally grouped into two types: internal and external. In our paper, we analyzed board of directors and shareholding structure as internal mechanisms, and audit as an external one.

Board of directors: The board of directors is often considered as one of the most essential and important control mechanisms. However, board effectiveness depends on several characteristics that include independence of board members, board size, separation of the roles of CEO and board Chairman and existence of an independent audit committee.

Independence of board members: according to agency theory, board effectiveness increases with the proportion of independent directors. Accordingly, corporate governance reports (Bouton, 2002; Cadbury, 1992; Viénot, 1995, 1999) recommend companies introduce independent directors to their board. Several previous studies have also argued that the presence of independent outside directors on the board improves its effectiveness and constitutes a constraint on fraud (Abbott, Parker,