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The International Journal of Accounting 47 (2012) 333 – 355

The International Journal of Accounting

The Effect of IFRS Adoption and Investor Protection on Earnings Quality Around the World ☆

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Received 19 July 2010

Abstract

This study examines the effects of mandatory IFRS adoption and investor protection on the quality of accounting earnings in forty-six countries around the globe. The results suggest that earnings quality increases for mandatory IFRS adoption when a country's investor protection regime provides stronger protection. This study extends the current literature that shows that accounting practices are influenced by country-level macro settings. The results highlight the importance of investor protection for financial reporting quality and the need for regulators to design mechanisms that limit managers' earnings management practices.

Keywords: Earnings quality; Discretionary accruals; Accruals quality; Earnings persistence; Micro governance; Macro governance
JEL classification: J3; K2; M4

☆ We thank Ira Solomon, Mark Peecher, Andreas Charitou, Zhaoyang Gu, Ken Kong, Susumu Ueno and Yuan Ding for their helpful comments on earlier versions of the paper. We are grateful for the comments made by the participants at the 2010 Illinois International Accounting Symposium (especially the discussant, T. Jeanjean), the 2011 AFAANZ Conference, Darwin, Australia, the 2010 Finance and Corporate Governance, La Trobe University, Australia, and the 2010 Asian-Pacific Conference on International Accounting Issues, Gold Coast, Australia. We also thank the anonymous reviewers of The International Journal of Accounting and the editor A Rashad Abdel Khalik for many constructive suggestions.
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0020-7063/$ - see front matter
doi:10.1016/j.intacc.2012.07.003

1. Introduction

The FASB/IASB conceptual framework identifies relevance and representational faithfulness as the fundamental qualitative characteristics that determine the usefulness of accounting information for making economic decisions. Accounting earnings information is relevant if it is capable of making a difference in users' decision making; that is, if it has predictive or confirmatory value, or both. This information can be a perfectly faithful representation if it is complete, neutral, and free from error (FASB/IASB, 2010: Chapter 3). Recent research suggests that strong investor protection, strong legal enforcement, and a common law legal system are fundamental determinants of high-quality financial statement numbers (Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003; Cai, Rahman, & Courtenay, 2008; Daske, Hail, Leuz, & Verdi, 2008; Francis & Wang, 2008; Hope, Jin, & Kang, 2005; La Porta, Lopez-de-Silanes, & Shleifer, 2006; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998, 2000, 2006; Leuz et al., 2003; Nabar & Boonlert-U-Thai, 2007). A further and likely important determinant of the quality of accounting information is the adoption of International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB). More than 134 countries currently permit or require IFRS, including the EU countries, Australia, New Zealand, and many developing countries. Since the announcement of IFRS adoption, national accounting differences have decreased and the present international accounting setting provides an opportunity to examine why there are differences in earning quality.

This paper makes several contributions to the current literature. Using a large sample of firm year observations from 46 countries for the years 1998–2007, our results suggest that earnings quality increases for mandatory IFRS adoption where a country's investor protection regime offers stronger protection for its investors. These findings are consistent with the argument that cross-country differences in accounting quality are likely to remain after mandatory IFRS adoption where there is poor investor protection (Daske et al., 2008; Jamal et al., 2010; Soderstrom & Sun, 2007; Sunder, 1997). International studies on earnings quality tend to focus on developed economies and on a limited number of countries. This study uses a large sample of firms in both developed and emerging economies and thus offers the potential for better understanding the global impact of IFRS adoption. Finally, the study also examines the effects of mandatory IFRS adoption and investor protection on the quality of accounting earnings at firm level. This allows for variation not only across countries but also across firms within countries.

In Section 2, we set out the theoretical framework for the study and develop the hypotheses. In Section 3, we describe the measures of investor protection that we use in the study. In Section 4, we discuss the research design and sample selection. In Section 5, we present our results and in Section 6, our conclusions.

2. Theoretical framework and hypothesis development

Improvement of accounting earnings quality depends on at least two factors: high quality accounting standards and a country's overall investor protection (Soderstrom & Sun, 2007). The adoption of a common set of accounting standards such as IFRS improves earnings quality because management is under pressure to provide a true and fair view and engage in fewer earnings management activities. Ewert and Wagenhofer (2005) noted this