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The International Journal of Accounting 46 (2011) 205 – 230

The International Journal of Accounting

Board Monitoring and Earnings Management Pre- and Post-IFRS☆

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Received 27 February 2009

Abstract

In this paper, we address the question of whether the board of directors is more effective in constraining earnings management after the mandatory application of IFRS. Specifically, we explore how two board characteristics — board independence and (2) the existence of an audit committee impact earnings management. Our empirical results suggest that board independence and audit committees play an important and effective role in reducing earnings management after the introduction of IFRS and that the accounting regulatory framework significantly contributes to the effectiveness of the two corporate governance mechanisms. Our findings also confirm that a company's corporate governance characteristics remain an important determinant of earnings quality; therefore, an analysis of the effects of new regulations must consider firm-level determinants.
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Keywords: Board independence; Audit committee; Earnings management; IFRS

☆ We thank Sasson Bar-Yosef, Lale Guler, Marcello Bianchi (CONSOB), and the participants at the 30th European Accounting Conference, Lisbon, 2007, and at the 12th Annual Financial Reporting and Business Communication Conference, Cardiff, 2008, for their helpful comments and suggestions. The authors gratefully acknowledge CAFRA — Centro di ricerca sull'Amministrazione, Finanza e Regolamentazione delle Aziende (Accounting, Finance and Companies Regulation Research Center), Universita' Bocconi, for financial support.

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0020-7063/$ - see front matter © 2011 University of Illinois. All rights reserved.
doi:10.1016/j.intacc.2011.04.007

1. Introduction

In 2005, with the adoption of International Financial Reporting Standards (IFRS), European Union-listed companies faced a major change in their accounting disclosure rules. Although there is evidence that the implementation of international accounting standards leads to a general improvement in earnings quality (Barth, Lanndsman, & Lang, 2008), the application of IFRS still involves considerable managerial judgment and the use of private information (Daske, Hail, Leuz, & Verdi, 2008), thus leaving firms with a substantial amount of discretion. Several studies highlight the environmental and firm characteristics that play a significant role in determining how firms use discretion, even in the presence of higher-quality standards (e.g., Ball, Kothari, & Robin, 2000; Ball, Robin, & Wu, 2003; Ball & Shivakumar, 2005; Burgstalher, Hail, & Leuz, 2006; Leuz, 2003). However, we believe that there is still a need for research on the role played by firms' characteristics (e.g., corporate governance structure) in the quality of financial reporting.

The board of directors is generally considered a crucial player for corporate governance, particularly when it comes to monitoring top management (Fama & Jensen, 1983). The debate over corporate governance emphasizes the positive contribution that independent board members provide in ensuring that top management acts in the interest of stockholders (Fama, 1980; Fama & Jensen, 1983). Prior research also highlights the role of boards in constraining earnings management activities, especially focusing on two aspects of board composition and structure: (1) the presence of outside or independent directors and (2) the existence of an audit committee. While prior empirical research widely supports the hypothesis that earnings management is negatively related to the proportion of outside directors on the board, that is, earnings management is reduced when there is more independence (Beasley, 1996; Dechow, Sloan, & Sweeney, 1996; Klein, 2002b), the audit committee's effect on earnings management activities is more controversial. Some scholars find evidence that the presence of an audit committee limits earnings management (Bèdard, Chtourou, & Courteau, 2004; Klein, 2002b), while others do not find significant relationships (Beasley, 1996; Peasnell, Pope, & Young, 2005).

Accounting scholars recognize the importance of boards as a crucial internal control mechanism and thoroughly analyze some board features' impact on its monitoring activity. However, to the best of our knowledge, the boards' effectiveness in constraining earnings management after IFRS introduction has not yet been explored.

In this paper, we attempt to address this gap in the research literature. We hypothesize that, subsequent to the implementation of the new accounting standards, the board of directors becomes more effective in constraining the extent of earnings management. In particular, we expect a stronger negative relationship between the level of earnings management and both board independence and the existence of an audit committee after the introduction of IFRS. This stronger negative relationship translates into a more limited ability for the board to manage earnings.

The study is based on a sample of 222 unique Italian-listed firms that mandatorily switched from the Italian GAAP to the IFRS in 2005. By focusing on a single country, we can better isolate the effects of the new standards' implementation on the boards' monitoring activities, since most other institutional and environmental factors remain constant over the period under investigation.

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