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The effect of IAS/IFRS adoption on earnings management (smoothing): A closer look at competing explanations ☆

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A B S T R A C T

Prior research provides mixed evidence on whether the transition to IAS/IFRS deters or contributes to greater earnings management (smoothing). The dominant explanation for the conflicting results is self-selection. Early voluntary adopters had incentives to increase the transparency of their reporting in order to attract outside capital, while those firms that waited until IFRS adoption became mandatory in EU countries lacked incentives for transparent reporting leading to increases in earnings management (smoothing) after IFRS adoption. We maintain that the IFRS standards that went into effect in 2005 provide greater flexibility of accounting choices because of vague criteria, overt and covert options, and subjective estimates. This greater flexibility coupled with the lack of clear guidance on how to implement these new standards has led to greater earnings management (smoothing). Consistent with this view, we find an increase in earnings management (smoothing) from pre-2005 to post-2005 for firms in countries that allowed early IAS/IFRS adoption, as well as for firms in countries that did not allow early IFRS adoption. We find no evidence of changes in incentives that can explain these results.

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1. Introduction

Prior research provides mixed evidence on whether the transition to IAS/IFRS deters, or contributes to, greater earnings management (earnings smoothing). Barth et al. (2008) find a decrease in earnings management (smoothing) following firms' *voluntary* early adoption of IAS/IFRS over the 1994–2003 period. Ahmed et al. (2013) and Christensen et al. (2015) find that earnings management (smoothing) has increased following the 2005 *mandatory* IAS/IFRS adoption in the European Union (EU). The dominant explanation offered by Ahmed et al. (2013)[1] for these conflicting results is self-selection of firms that voluntarily adopt IAS/IFRS rather than the effects of IFRS standards, per se. Early adopters of IFRS had incentives to increase the transparency of their reporting in order to attract outside capital, and, therefore, earnings management (smoothing) went down after *voluntary* IFRS adoption, while those firms that waited until IFRS reporting became mandatory in EU countries lacked incentives for transparent reporting leading to increases in earnings management (smoothing) after *mandatory* IFRS adoption.

In this paper we offer another explanation for the conflicting findings. We show that IAS/IFRS standards changed substantially from the pre-2005 early voluntary adoption period to the post-2005 mandatory adoption period. In effect, the IAS/IFRS standards used in testing for earnings management (smoothing) consequences of early voluntary adoption are quite different from the revised IAS/IFRS standards used to test the effects of mandatory adoption. Following the 2002 EU decision to make IFRS reporting mandatory, more than one third of the existing standards at that time (14 out of 34 IAS standards) were revised and six new standards (IFRS) were introduced, all of which became effective in 2005. While some of the revised standards may have limited the opportunity to manage (smooth) earnings by reducing the number of allowed alternative accounting treatments, Nobes (2006) maintains that the post-2005 IFRS standards provide firms with greater flexibility of accounting choices because of vague criteria, overt and covert options, and subjective estimates that are allowed under these principle-based standards. Consistent with the claims by Nobes (2006), we document dissenting opinions from ten IASB board members on eight modifications to existing IAS or newly introduced IFRS standards, all arguing that 2005 changes in IFRS increase flexibility and lack clear implementation guidance. We hypothesize that this greater flexibility coupled with the lack of clear guidance on how to implement these new standards has led to greater earnings management (smoothing).

To test our hypothesis and to add to our understanding of the conflicting findings presented in prior studies, we analyze a sample of 3853 firms from 29 countries that transitioned to IAS/IFRS between 1994 and 2009. We break this broad sample down into three distinct groups: *Early Adopters* (firms that voluntarily chose to adopt IAS/IFRS before 2004), *Late Adopters* (firms that chose to delay adoption of IAS/IFRS until 2005 or 2006 in countries where early adoption was possible), and *Mandatory Adopters* (firms domiciled in EU countries that did not allow early adoption prior to the mandatory IFRS adoption date of 2005). By conducting over time and cross-sectional comparisons of these distinctly different samples around the 2005 mandatory adoption of IFRS, we are able to control for differences in incentives, which is another explanation for the conflicting findings in the prior research.

We find an increase in earnings management (smoothing) after 2005 for *Early Adopters* as well as for *Late Adopters* and *Mandatory Adopters*. Moreover, we find no differences in earnings management (smoothing) proxies between *Early Adopters* and *Late Adopters* in the post-2005 IAS/IFRS reporting regime. The fact that *Early Adopters,* firms with arguably high ex-ante incentives to improve their reporting and that were already reporting under (old) IAS/IFRS standards, exhibit an increase in earnings management (smoothing) after transitioning to the 2005 version of IFRS provides strong evidence that 2005 changes to IAS/IFRS increased firms' flexibility of accounting choices and this, couple with the lack of implementation guidance, has contributed to greater earnings management (smoothing). This interpretation is supported by the same pattern of increased earnings management (smoothing) that we observe for *Mandatory Adopters,* firms with no choice of adopting IAS/IFRS early.

Additional analyses of firm characteristics hypothesized to be related to firms' incentives for transparent reporting provide further support for our claim that differences in the flexibility of different

[1] Christensen et al. (2015) are more agnostic and recognize that they are unable to distinguish between these explanations (self-selection or effect of IFRS).