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IFRS and U.S. GAAP: Assessing the impact of reporting incentives on firm restatements in foreign and U.S. markets

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ABSTRACT

This study examines the impact of reporting incentives on firm restatements in foreign and U.S. markets. We investigate whether financial reporting, using International Financial Reporting Standards (IFRS) results in quality disclosures, given differences in institutional and market forces. This study examines the quality of financial statements prepared in accordance with IFRS and U.S. GAAP by concentrating on firm restatements as a measure of earnings management. Our results indicate that there is no significant difference in the value of restatements due to differences in accounting standards when the rule of law is high in the international market. Furthermore, firms with better law enforcement and higher traditions of law and order, tend to have smaller restatement amounts or less earnings manipulation. This study contributes to the literature by providing evidence of the quality of financial information prepared under IFRS and its dependency on the institutional factors and market forces of a country.

1. Introduction

This paper examines the impact of reporting incentives on firm restatements in foreign and U.S. markets. In this study, we investigate whether financial reporting, using International Financial Reporting Standards (IFRS) results in quality disclosures, given differences in institutional and market forces. This study examines the quality of financial statements prepared in accordance with IFRS and U.S. GAAP by concentrating on firm restatements as a measure of earnings management. U.S. companies in 2006 issued a record 1420 financial restatements, up from 1255 restatements in 2005. Foreign-based companies registered with the Securities and Exchange Commission for doing business in the United States issued 118 restatements in 2006, up from 103 in 2005. In this study, earnings management is viewed as having an inverse relationship to earnings quality (i.e. high earnings quality is synonymous with low earnings management).

Recent interest in global accounting standards has resulted in considerable debate as to whether IFRS result in high quality financial reporting (Ashbaugh & Pincus, 2001; Barth, Landsman, & Lang, 2008; Cuijpers & Buijink, 2005). U.S. Generally Accepted Accounting Principles (U.S. GAAP) is frequently viewed as the benchmark for high-quality global standards (Levitt, 1998; McGregor, 1999). Moreover, the FASB has published a comparison on the differences in U.S. GAAP and IFRS and finds significant differences between them. Prior studies examining the quality of financial information prepared using IFRS compared to U.S. GAAP have presented mixed results (Ashbaugh & Olsson, 2002; Harris & Muller, 1999; Leuz, 2003).

A number of studies consider the benefits of IFRS by examining the actions of preparers and users of financial reporting information after a firm endorses IFRS. For instance, Covrig, Defond, and Hung (2007) argue that firms voluntarily adopting International Accounting Standards (IAS) attract foreign investors thus improving capital allocation efficiency. However, Ball, Robin, and Wu (2003) indicate that the global accounting debate focuses too much on the choice of accounting standards and too little on market forces and institutional factors. This study contributes to the global accounting debate by utilizing U.S. based companies complying with U.S. GAAP as a benchmark for measuring the quality of IFRS as applied by foreign-based companies registered with the Securities and Exchange Commission. Francis, Khurana, and Pereira (2003) found that common law countries have higher quality accounting and auditing standards and the enforcement of such standards through higher quality auditing is more likely to exist than in civil law countries. Furthermore, Burgstahler, Hail, and Leuz (2006) note that capital market pressures and institutional factors shape firms' incentives to report earnings that reflect economic performance.

Given the differences in institutional and market forces for the U.S. and foreign-based registrants with the SEC, management's incentives to engage in earnings management may outweigh the costs. Ball, Kothari, and Robin (2000) argue that when the costs of complying with IFRS are viewed as exceeding the costs of non-compliance, substantial non-compliance will occur. In this study, earnings management (quality) is determined by examining firm restatements for U.S. and foreign-based companies registered with the SEC. We

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compare firm restatements for the period 2003–2007 for U.S firms and foreign registrants with the SEC. This allows a comparison between companies operating under different institutional factors and market forces that have adopted IFRS versus companies that report under U.S. GAAP.

2. Literature and hypothesis

Prior market-based comparison studies examining the quality of financial information prepared under IFRS with financial information prepared under U.S. GAAP have presented mixed results. Harris and Muller (1999) find that U.S. GAAP earnings reconciliation adjustment is value-relevant and that U.S. GAAP amounts are valued differently for market value and return models than IFRS amounts. Similarly, Ashbaugh and Olsson (2002) in an examination of non-U.S./non-U.K. firms find that the earnings capitalization model is the dominant accounting-based valuation model when cross-listed firms report under IFRS. However, the residual income model is the dominant accounting-based valuation model for cross-listed firms reporting under U.S. GAAP. Leuz (2003) examined firms in Germany's “New Market” for growth firms, which are required to choose between IFRS and U.S. GAAP in preparing their financial statements. Leuz's findings do not indicate that U.S. GAAP is of higher quality than IFRS. Differences in the bid-ask spread and share turnover across IFRS and U.S. GAAP firms are statistically insignificant. Similarly, Leuz and Verrecchia (2000) find in a cross-sectional analysis that firms that commit to either IFRS or U.S. GAAP exhibit lower percentage bid-ask spreads and higher share turnover than firms following German GAAP.

Few studies have examined earnings management practices in non-U.S. countries. Darrough, Pourjalali, and Saudagaran (1998) examined the choices of accounting accruals using a large sample of Japanese companies. The results of the study indicate that similar to managers of U.S. firms, managers of Japanese companies chose income-increasing accounting accruals to increase their bonuses and to increase the amount of outside funding. Management's incentive to manage earnings may significantly affect the quality of earnings in cross-listed firms reporting financial information under IFRS. Management has incentives to adjust accounting earnings to maximize firm and/or manager wealth. The more discretion given to management in financial reports, the greater the opportunity for more manipulated and thus less quality reported financial disclosures. While prior research usually focuses on single countries using data from limited time intervals; Barth et al. (2008) examine 21 countries and use an assortment of quality measures during a common time period (1994–2003). Evidence from their study suggests that, in many countries, adoption of IFRS tends to result in higher quality earnings compared to the use of non-U.S. domestic standards. They found that firms endorsing IAS display less earnings smoothing, less management towards positive earnings, and more timely recognition of losses. While including research design features to mitigate the effect, the authors acknowledge that changes in firms' incentives and the economic environment may have contributed to their results. In an investigation of the variation in accounting standards across 13 countries relative to International Accounting Standards (IAS), Ashbaugh and Pincus (2001) find that analyst forecast accuracy improves after firms adopt IAS. The authors suggest that the improvement in analyst forecast accuracy associated with the adoption of IAS indicates that analysts can make more accurate predictions of earnings.

Francis et al. (2003) in an examination of 31 countries found that financial disclosures are more transparent and national accounting standards require timelier (accrual based) reporting in countries with stronger investor protection (common law countries). The authors address the debate regarding international accounting standards by suggesting that in the absence of a change in market forces and institutional factors, simply transplanting accounting rules from one country to another is futile. Similarly, Ball et al. (2003) argue that the global accounting debate focuses too much on the choice of accounting standards and too little on market forces and institutional factors. Although, Francis et al. (2003) found that common law countries have higher quality accounting and auditing standards and the enforcement of such standards through higher quality auditing is more likely to exist than in civil law countries, differences existed in values for variables within common law countries. Given the differences in institutional and market forces for the U.S. companies and foreign-based companies registered with the SEC, management's incentives to engage in earnings management may outweigh the costs. Ball et al. (2000) argue that when the costs of complying with IFRS are viewed as exceeding the costs of non-compliance, substantial non-compliance will occur. Burgstahler et al. (2006) found that legal institutions and capital market forces often appear to reinforce each other. In our study, earnings management (quality) is determined by examining firm restatements for the U.S. and foreign-based firms registered with the SEC. Francis et al. (2003) find that higher quality accounting and auditing are positively associated with financial market development in countries whose legal systems are conducive to protection of investors.

La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1997) in an examination of the rule of law (character of legal rules and the quality of law enforcement) of 49 countries show that countries with poorer investor protection have smaller and narrower capital markets. They argue that differences in the nature and effectiveness of financial systems in various countries can be traced in part to the differences in investor protections, as reflected by legal rules and the quality of their enforcement. We compare the restatements of foreign-based firms registered with the Securities and Exchange Commission with restatements for U.S. firms. Based on the above arguments, we hypothesize the following:

H1. Financial restatements for foreign firms with strong legal systems associated with greater investor protection are not significantly different from that of U.S. firms.

This study examines the quality of financial statements under IFRS by comparing the issuance of firm restatements under IFRS with firm restatements under U.S. GAAP, given differences in institutional and market forces.

3. Research methodology

3.1. Sample selection

We began our sample selection of companies issuing restatements by searching the Audit Analytics Database for restatements from years 2003–2007. The sample consists of U.S. companies complying with U.S. GAAP and foreign-based companies registered with the SEC. The sample includes only annual restatements because several variables of interest and control variables are defined on an annual basis. We screened sample companies to eliminate restatements caused by routine events such as mergers and acquisitions, divestitures, stock- or tax- related changes, or IPO registrations. We focused on restatements resulting from earnings management and accounting errors. The four primary reasons identified for restatements were errors in the valuation of assets, errors in accounting for stock related compensation, errors in accounting for investments and derivatives, and revenue recognition issues.

We dropped financial institutions and companies from highly regulated industries because the monitoring by additional regulators could distort our results. We also eliminated private companies and companies not regularly traded on U.S. stock exchanges. There were five international companies that did not use either U.S. GAAP or IFRS reporting standards. Our sample selection methodology resulted in a final sample of 468 firms as seen in Table 1.