

Earnings Management under IFRS and PGC

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ABSTRACT

There has recently been considerable discussion on the impact of International Financial Reporting Standards (IFRS) in financial reporting across European countries. The purpose of this paper is to examine whether the adoption of principles-based IFRS by Spanish companies has increased or decreased the scope for discretionary accounting practices—earnings management (EM). Another objective is to determine which firms' features and country factors may explain the accounting discretion observed before and after IFRS. Findings suggest that variations in EM might be due to some room for manipulation under IFRS when compared with local standards.

KEYWORDS

IFRS; PGC; Earnings Management; Institutional Context.

1. Introduction

Research has widely explored whether the application of International Accounting Standards (IAS), or International Financial Reporting Standards (IFRS) if published after 2001, is associated with higher earnings

quality and whether this cross country regulation improves the effects of previous domestic standards, such as the «Plan General de Contabilidad (PGC)». Accounting information is one of the major interests to external capital providers, suppliers, employees, customers, communities, and regulators. Ideally, financial reporting helps the better-performing firms to distinguish themselves from poor performers and facilitates shareholder (or investors) financial decision making (Healy & Wahlen, 1999). However, it is broadly understood that companies do not always pursue the objective of reflecting their true underlying performance but certain self-interested goals, which are extremely diverse and changeable over time. Earnings management (EM) has been frequently defined as the use of accounting techniques to produce financial reports that may paint a picture of a company's business activities and financial position that benefits the company's underlying (and not always clear) intentions.

One of the goals of the International Accounting Standard Board (IASB) is to develop an internationally acceptable set of high quality financial reporting standards to meet the criteria of relevance, reliability and comparability required by the IAS regulation. To achieve these goals, the IASB has issued principles-based common standards hoping to remove certain degree of discretion and accounting alternatives to better reflect a firm's economic position and performance (IASB [1989]).

The impact of implementing these international reporting standards on the quality of accounting information is not clear across research. The purpose of this paper is first to provide a broad vision of the determinants, objectives and consequences of changing from domestic accounting standards to a more generalist set of international standards such as IAS/IFRS. And second to examine whether this swift of standards has had any impact on the level of EM in Spanish companies.

2. Some insights on Earnings Management

Policy setters need to acknowledge the degree of quality on financial reporting; this requires both, measuring the amount of discretion in the accounting amounts, and detecting the reasons and determinants for this opportunistic behavior. We will first examine the reasons and determinants, and second we will glance at the big challenge of measurement.

It is relevant to note that some scholars claim that certain level of earnings manipulation can be beneficial for certain stakeholders as it may increase firm value and reduce agency costs, it may also produce more truthful forecasts,

and improve market perceptions (Jiraporn, Miller, Yoon, & Kim, 2008). For instance, earnings smoothing, as mentioned above, presenting a continuous growing line, instead of an ups-and-downs graph, improves the investors and analysts perceptions of the same accumulated results. Moreover, certain level of discretion is needed to introduce private information that exclusive hold by managers, and this increases informativeness and forecasting power of financial reporting. General acceptance, however, converges in stating that EM is negative related with earnings and reporting quality. Thus the basic aim of standard setters is to reduce the degree of managerial discretion in accounting figures as to improve stakeholder's information and decision making strategies.

Reasons and Determinants

One of the big challenges in deterring accounting manipulation is the comprehension of the different and changeable reasons companies might have to behave opportunistically. That also includes controlling for the existence of multiple manipulation techniques that can be employed.

Probably the most explored determinant for such behaviors is the strength of the true financial and economic performance of the firm. Firms with poor current earnings will borrow part of the future expected earnings to present a (desired) continuous growth. These companies use EM to smooth out fluctuations in earnings and/or to meet stock analysts' earnings projections. Large fluctuations in income and expenses may be a normal part of a company's operations, but the changes may alarm investors who prefer to see stability and growth (Healy & Wahlen, 1999). It is relevant to notice that a company's stock price will often rise or fall after an earnings announcement, depending on whether it meets, exceeds or falls short of expectations (Dechow, Hutton, & Sloan, 1996). Meeting (market/investors) expectations can become a striking incentive for managers to do with accounting gimmicks what they cannot achieve otherwise.

Another strong incentive to misuse accounting techniques is the avoidance of debt covenants violations. Firms with loans close to violation or in technical default of their debt covenants have greater incentives to engage in EM (Sweeney, 1994). We also find higher levels of accounting manipulation when companies are about to face equity offers, manager buyouts, or some other capital market incentives (Healy & Wahlen, 1999). Companies using earnings-based managerial contracts may also have higher «temptations» to help financial figures in favor of those contracts

(Watts & Zimmerman, 1986). Similarly, weak corporate governance and internal controls are been found positively related to higher discretion in accounting amounts as well as certain features in auditors firms, such as the size or the retribution fees of these auditors (Dechow, Ge, & Schrand, 2010). Many other factors have been studied as incentives or determinants for EM and Figure 1 summarizes most of them.

At the country level, we find that the magnitude of EM is on average higher in code-law countries (e.g. Spain) with low investor protection rights, compared to common-law countries (e.g. UK) with high investor protection rights (Leuz, Nanda, & Wysocki, 2003). Countries with strong outsider protection are expected to enact and enforce accounting and securities laws that limit the manipulation of accounting information reported to outsiders. Therefore, laws on director self-dealing are stricter and more reliable in countries such as U.K. and the U.S. than those in Germany, Italy or Spain. EM is found also more intensive in countries with high ownership concentration.

Alongside, a big debate in accounting research is open with regard accounting standards and its impact on EM. Scholars such as Barth, Landsman, and Lang (2008) hypothesize that IAS/IFRS increase earnings quality in part because the standards are principles-based, and they find evidence that use of is associated with less EM, more timely loss recognition, and greater value relevance. While others like Callao and Jarne (2010) find evidence of an increase in EM when adopting IAS/IFRS instead of original domestic standards, probably due to the former's higher flexibility and subjectivity in application of valuation criteria (e.g. fair value).

Firm characteristics	Firm performance Firm growth	Firm size Firm debt covenant Debt as a call option
Financial reporting practices	Accounting methods Other financial reporting practices	Principles based versus rules based methods
Governance and controls Board characteristics	Board of Directors Internal Control procedures Managerial ownership	Earnings-based compensation Equity compensation Managerial change Corporate Social Responsibility
Auditors	Auditor size Auditor fees	Non-audit fees Other auditor-related

Capital market incentives	Initial Public Offering and Seasoned Equity Offering Mergers buyout	Cross-listing Incentives to meet earnings-based targets
External factors	Political process Capital regulations	Tax regulations Sarbanes-Oxly Act (SOX)
Country-level institutional factors/legal systems	Enforcement in regulations Investor Protection	Common-law versus Code-law

Figure 1. Determinants and reasons for earnings management.

Measurement of Earnings Management

The real challenge of researchers has always been to disentangle the acceptable managerial judgment to favor financial quality and informativeness, from the misleading discretion used in search of a self-interested goal. This implies that we have to design a valuation model capable to capture what managers have in mind when applying accounting criteria. Inasmuch measurement of an unobservable intention is objectively impossible scholars use proxies such as abnormal accruals to detect EM.

Accrual basis accounting method although provides more information about the performance of a firm than cash basis method, it embodies higher managerial discretion inasmuch accountants introduce subjectivity in accounting choices. Researchers try to capture that subjectivity measuring the amount of accruals that are not explained by the cash flow, revenues or amortizations of the company. That «abnormal» amount of accruals is used in most studies as a proxy to infer the engaged EM after controlling for the size and the industry of the company.

One of the first models was designed by Jenifer Jones in 1991, and after that numerous empirical strategies have been developed to attempt to capture the managerial discretion of financial reporting. The Jones model measures the abnormal accruals of individual companies compared to same industry averaged accruals. A short summary of the most common measurement models can be found in Figure 2.

<p>Jones Model (1991)</p> <p>Accruals are considered a function of Revenue growth and Depreciation (as a function of Plant, Property and Equipment). The residual of this model is the amount of discretion not explained by those economic variables.</p>
<p>Modified Jones model (Dechow, Sloan and Sweeney, 1995)</p> <p>Accruals in period t as a function of the difference between Revenues growth and Receivables growth and as a function of Plant, Property and Equipment (PPE). This model adjusts Jones model to exclude growth in customer receivables.</p>
<p>Dechow and Dichev (2002) approach</p> <p>Variation in Working Capital as a function of Operating Cash Flows in period $t-1$, t, and $t+1$.</p> <p>Large divergences between WC and past, present and future cash flows infer high discretion in accounting accruals.</p>
<p>Earnings Smoothness and Earnings Aggressiveness (Leuz et al. 2003)</p> <p>Variation in Earnings/Variation in Cash Flows. Captures the degree to which managers reduce the variability of reported earnings altering accruals. Managers might have incentives to delay losses (earnings smoothness) or accelerate gains (earnings aggressiveness) to meet certain goals. Extreme low values of this ratio indicates smoothing while extreme large values indicate aggressiveness.</p>
<p>Earnings losses/decreases Avoidance (Chih, Shen & Kang 2008)</p> <p>Difference between the actual and expected number of firms having small profits. Managers might have incentives to avoid presenting small losses and help accounting numbers to cross the zero profit line. Discontinuity around zero profits.</p> <ul style="list-style-type: none"> • Number of companies with small positive earnings is unusually high. • Number of companies with small losses is unusually small.
<p>External indicators of financial reporting quality</p> <ul style="list-style-type: none"> • Accounting and Auditing Enforcement Releases (AAERs) identified by SEC. • Restatements. • Sarbanes-Oxley Act reports of internal control deficiencies. <p>Firms had amendments or are likely to have had errors in their financial reporting systems, which imply low quality of accounting figures.</p>

Source: (Dechow, Ge, & Schrand, 2010).

Figure 2. Summary of Measurement Models¹.

1. All variables are scaled by Total Assets to control for the size of the company (e.g. Revenues/TA).

3. IFRS implementation

The growth of international financial markets and changes on investor behavior has, among other factors, aroused the need for harmonization of accounting standards to allow cross national interpretation and understanding of financial reporting. Considerable efforts have been made by various bodies (International Accounting Standards Board (IASB) and the European Union (EU)), since the 1970s to harmonize accounting rules in different countries finally resulting in the approval of Regulation 1606/2002, which provides for application of International Financial Reporting Standards (IFRS) by business groups listed on European stock markets. All listed EU companies are required (mandatory) to prepare their *consolidated financial statements* in accordance with IFRS for years beginning on or after January 1, 2005. The approval of this regulation has resulted in different adoption processes of IFRS in European countries (e.g. Spanish companies completed their process as in 1st of January 2008).

Opponents of harmonization note the magnitude of the differences that exist between countries and the high cost of efforts to eliminate those differences. They argue that because of the existence of different institutions, legal and accounting traditions, and environmental conditions, differences in accounting across countries might be appropriate and necessary. A single set of international standards might not accommodate those differences (Amstrong, Barth, Jagolinzer, & Riedl, 2007).

Proponents of accounting harmonization suggest that there are many potential benefits that may arise from the use of one common set of accounting standards. These include improved transparency, comparability and quality of financial reporting that lead to lower preparation costs, more efficient investment decisions and lower cost of capital for companies (Choi & Meek, 2005).

Finally, the key issue is not whether harmonization is necessary or not, decision was made, but *to what extent* and *how fast* domestic and international standards have to converge. Countries have adapted differently such convergence. Some countries have adopted IFRS directly while others (e.g. Spain) have issued an IFRS-adapted domestic standard. We can summarize the characteristics and implications of this cross-country implementation as follows:

- Most firms adopted IFRS at first stage for more than just consolidation purposes. Accordantly to a survey done by Jermakowicz and Gornik-Tomaszewski (2006) a third part of respondents indicated that their

conversion process went beyond external reporting, and IFRS-based information would be used for internal decision-making.

- The process is costly, complex, and burdensome for all countries, but especially for those which accounting regulation was based on a completely different system, and professional tradition.
- The more comprehensive and soft the conversion process the more respondents tend to agree with the transition.
- The complexity of IFRS as well as the lack of implementation guidance and uniform interpretation are key challenges in convergence.
- A majority of companies would not adopt IFRS until it becomes mandatory by the EU Regulation. Adoption was primarily mandatory for listed companies preparing consolidated financial reports (January 1st 2005) and voluntary for the rest. Complete compliance process ended January 1st 2008.

In order to facilitate this convergence, the IASB has put a lot of effort in designing a set of principle-based standards, flexible enough, to be «absorbed» by the different countries' regulations.

Companies' Incentives for IFRS adoption

Nevertheless, the effort of IASB to enforce the adoption of international standards across countries, it is not sufficient to explain how accounting standards have gained widespread acceptance. Arguably, harmonized accounting standards need to meet some technical features to enable acceptance by countries with diverse cultures and reporting traditions.

Implementation of IFRS is not a cost-free process, and must be accompanied of some side benefits for companies' voluntary adoption. Several studies have tried to determine the main factors motivating voluntary adoption of IAS/IFRS. Most of them have focused on consolidated quoted companies and have studied one or several European countries. Generally, empirical evidence has been provided of the positive influence of factors such as size, internationality, listed status or growth on voluntary compliance with IFRS. Some empirical research had underlined the presence of incentives such as political costs or international market pressures to overcome the costly process of implementing IFRS (Dumontier and Raffournier [1998]). Companies geographically disperse as well as those domiciled in countries with lower quality reporting standards, may find beneficial to decide for

IFRS instead of local standards. And less developed countries can decide for IFRS adoptions to incentivize the development of institutions which facilitate private contracting (Doidge, Karolyi, & Stulz, 2007). Other studies propose that a commitment to increased levels of disclosure, because they believe the market perceives IFRS as higher quality than domestic standards, reduces information asymmetries among stakeholders resulting in a reduction of the cost of capital (Baiman and Verrecchia [1996]). Signaling transparency and truthfulness is becoming more and more important for companies in continental Europe since ownership and financing is shifting to public equity markets.

IFRS, Domestic Standard «PGC», and Earnings Management

Notwithstanding the fact that the IAS/IFRS standards constitute a step forward in the process of accounting harmonization, there is still a long way to go in the comparability and quality improvement of accounting measures across countries and regions. The impact of IFRS on reporting and accounting quality has been the object of many studies since harmonization process began.

General acceptance in academic research converges in stating that EM is negative related with earnings and reporting quality. Nevertheless, it is relevant to note that some scholars claim that certain level of earnings manipulation can be beneficial for certain stakeholders as it may increase firm value and reduce agency costs, it may also produce more truthful forecasts, and improve market perceptions (Jiraporn, Miller, Yoon, & Kim, 2008). However, the general aim of standard setters is to reduce the degree of managerial discretion in accounting figures as to improve stakeholder's information and decision making strategies.

Accounting research has not been clear of the effectiveness of international standards in reducing the manipulation of earnings. Some studies find evidence of IFRS being associated with less EM although that these relationship cannot be disentangled from the existing institutions, which affect the demand for information, the enforcement, and the fundamental firm characteristics of the IAS adopters (Barth, Landsman, & Lang, 2008). On the other hand, we can also find empirical evidence that EM has intensified since the adoption of IFRS in Europe because of more room for manipulation under IFRS when compared to domestic standards (Callao & Jarne, 2010) or because the shift from a rules-based system to a principles-based system implying an increase of professional judgment (Wüstemanna

& Kierzek, 2005). At the same time, other researchers have found no differences in the extent of EM when comparing IFRS and national standards (VanTendeloo & Vanstraelen, 2005).

Despite the lack of agreement on the effect of IFRS in EM, an academic convergent argument is the fact that other features, such as the interpretation of standards, enforcement, institutions and litigation, are possibly more relevant for reduction of EM than the standards themselves. Standard setters often forget the role of institutional factors and market forces in shaping firms' incentives to report informative earnings. Simply adopting IFRS may not necessarily improve national accounting systems unless countries also implement profound changes in economic development policy, corporate governance mechanisms, and capital market regulations (Ding, Hope, Jean-jean, & Stolowy, 2007). Many scholars agree that the increase of accounting information content following mandatory adoption IFRS is dependent on the strength of legal enforcement in the adopting country and find that, in many cases, disclosed accounting policies are frequently inconsistent with IFRS (Street & Gray, 2001).

Additionally to the uncertainty towards the positive effect of IFRS if not accompanied of a strong institutional and legal system, scholars also question whether this effect is attributable to the change in standards or to other possible changes that might have occurred simultaneously. In recent years, a large number of countries have made reporting under International Financial Reporting Standards (IFRS) mandatory. This clustering in calendar time makes it difficult to isolate the effects of IFRS reporting (Chirstensen, Hail, & Leuz, 2012, p. forthcoming). Also, Land and Lang (Supplement 2002) show that accounting quality is improving worldwide. Therefore, any improvement in accounting quality we observe after firms adopt IFRS could be obtained even if firms do not adopt IFRS.

Transition from PGC to IFRS

The adoption of IFRS in Spain was first implemented for listed companies (Law 62/2003, 30 December) applying exclusively to consolidated financial statements prepared by companies required to report mandatory consolidated accounting information in years commencing as of January 1, 2005. Transition from a highly codified reporting framework to a principles-based framework was perceived as difficult, mainly because of valuation methods and recognition criteria, that Spanish users are not familiar with. That was the main reason why Spanish setters, following the recom-

mentations of an expert committee², decided to adapt the PGC to the international standards instead of presenting annual accounts based directly on IFRS. This adaptation process ended with the approval of the Royal Decree 1514/2007, resulting in the new IFRS-based PGC that was to be implemented by companies choosing between 1st of January 2007 and 1st of January 2008. This option was given to help companies in their transition.

Most companies were concerned for the increased level of disclosure required, fair value accounting, lack of practical guidance for certain issues, and the feeling that sector adaptation of standards might be needed for certain industries. The non-listed companies saw the move to IFRS as very long and costly process, which discourages them from changing on voluntary bases.

Implementation of IFRS started with voluntary disclosure in 2003 and ended as mandatory application in January 2008. A very long and complex transition that could not be innocuous to financial reporting. On the other hand, it is non irrelevant the fact that companies were allowed to choose between two different dates as their transition date. The first option (January 2007) committed firms to presenting comparative financial statements while the second (January 2008) allowed them to disclose only the adjustments in equity with no comparative information. This soft transition disregarded IFRS regulation (article 5 and 9)³ that only allows different timing of application under some specific circumstances to ensure transparency and comparability. Since comparability was not respected, a gap for discretion was open. Consequently, we cannot know whether the changes in the financial statements are due to the economic situation or to the change in regulation (Fitó, Gómez, & Moya, 2012). IAS Framework considers comparability to be one of the main characteristics for making accounting information reliable and useful.

Regarding SMEs, the reform has a great impact due to the fact that they have been provided with its own conceptual framework for the first time. The most important reason to create a specific PGC for SMEs is to apply for these companies a simplify criteria to avoid high costs of financial reporting and to facilitate its understanding, by means of regulations especially addressed to their most frequent operations. Moreover, SME's do not

2. Libro Blanco, published by the Spanish Government in 2002 (Instituto de Contabilidad y Auditoría de Cuentas, 2002).

3. The Regulation (EC) No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards¹ (IAS Regulation) harmonizes the financial information presented by public listed companies in order to ensure a high degree of transparency and comparability of financial statements.

need to inform the public or investors of their operations, as large and quoted companies are, but the scope of outside interest for their situation focuses mainly on its creditors.

However adaptable this transition has been in Spain, implementation of standards is not sufficient to improve the quality of reporting, much less to reduce the accounting «engineering». We must understand the legal tradition and environmental conditions surrounding the process as well as the institutional enforcement of those standards. One of the most relevant environmental conditions is the legal framework of accounting regulations and whether this regulation is based on rules or principles.

Principles-based vs. Rules-based

A distinctive feature of the IAS/IFRS standards is that they are principles-based (e.g. UK legal system) instead of rules-based (e.g. Spanish legal system). Simply stated, principles-based accounting provides a conceptual basis for accountants to follow instead of a list of unavoidable rules. Principles-based approach lays out the key objectives of good reporting and provides guidance explaining the objective and relating it to some common examples. Similarly, rules-based driving code would state «Speed limit in Spanish highways is 120 km/h» while a principles-based regulation system will set a recommendation such as «When driving conditions are adverse, cars shall reduce their speed».

The principle-based vs. rules-based debate began after the failure of Enron in October 2001. The initial argument was that principles-based standards, as being the opposite of rules-based standards, would address any problems created by the later. Despite division of opinions, on the relative merits and demerits of both approaches, the IAS/IFRS finally relied on a principles-based system to set accounting standards. One of the attractiveness of this system is the flexibility that allows global acceptance of the standards. In this respect, Carmona and Trombetta (2008) explain that the inner flexibility of the principles-based approach enables the application of IAS/IFRS in countries with diverse accounting and institutional and legal tradition.

Flexibility, however, turns out to be a double-edged factor in the nature of IAS/IFRS. While some empirical research suggests that firms increase voluntarily adoption IAS/IFRS because its adaptability to country-specific systems, others, such Jeanjean and Stolowy (2008) find that more flexible rules involve a higher degree of subjectivity in the application of criteria, allowing managers a wide field to exercise their discretion (Nobes, 2005;

Schipper, 2003; Nelson, 2003). This might affect quality of reporting and opportunistic behaviors.

Van Beest (2009) provides empirical evidence⁴ that managers engage in accounting decisions more in a principles-based setting than in a rules-based setting. Principles-based standards leave more room for professional judgment. This flexibility, however, may also be used to engage in EM. On the other hand, while rules-based standards reduce opportunities for earnings management through judgment (accounting decisions), allows managers to engage in more transaction decisions (real activities earnings management). Real activities manipulation is defined as management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings thresholds. At the end we may find no variation in total EM (accrual based plus real activity based) when switching from rules-based to principles-based standards, or vice versa. This controlled experiment allows the authors to test the influence of IFRS standards in isolation from institutional, legal and contextual factors.

Environmental and institutional factors in Spain

The quality of reported financial statements is largely determined by the institutional factors. Institutions are tightly shaped by the legal tradition of each country and according to La Porta et al. (1998) these can be classified as common-law countries and civil-law countries. Most English speaking countries belong to the common law tradition based on the British Company Act. The rest of the world belongs to the civil law tradition, derivative of Roman law, which has three main families: the French family based on the Napoleonic Code of 1804 (which includes Spain), the German family based on Bismarck's Code of 1896, and the Scandinavian family which legal scholars describe as less derivative of Roman law but «distinct» from the other two civil families.

Common-law countries have built large arm's length debt and equity markets, high risk of litigation and strong investor protection. Due to the high quality of public financial information there is no need to access private corporate information. Accounting information is then oriented to meet the needs of investors. In civil law countries, on the other hand, capital markets are smaller, investor protection is weak, litigation rates are lower

4. Van Beest (2009) ask 175 financial managers to decided on both an available-for-sale security to sell and an impairment loss decision to consider; an opportunity to take an accounting decision and a transaction decision to engage in earnings management, under principle-based and rules-based regulations in a 2×2 experiment.

and companies are more frequently financed by banks. Therefore, accounting information is shaped by other incentives (Ball, 2009).

Leuz, Nanda and Wysocki (2003) find empirical evidence that EM is more prevalent in code-law countries, compared to common-law countries, inasmuch as economies with relatively dispersed ownership, strong investor protection, and large stock markets exhibit lower levels of EM than countries with higher concentrated ownership, weak investor protection, and less developed stock markets. It is not by chance that Spain fits perfectly the later definition: civil law country with low investor protection, small market and tight ownership concentration, the perfect set to engage in high accounting discretion.

We may expect, however, that firms voluntarily adopting IFRS can have higher incentives to report investor-oriented information and thus engage in significantly less EM than non-adopters. But we cannot forget that low enforcement and low litigation risk might encourage low quality firms to falsely signal to be of high quality by adopting IFRS (VanTendeloo & Vanstraelen, 2005)⁵. It can be a double-edged sword.

Several studies such as Joos and Lang (1994), reveal that common-law countries are less conservative than code-law countries. It is likely that conservatism has some impact on accounting quality from the moment that shapes the choice of recognition and valuation criteria among the options provided by IFRS. We might expect this conservatism to diminish when adopting IFRS, however, the study of Callao et al. (2007) found no such reduction. The true difference between common law and civil law may be seen rather in their different methods of legal thinking, hardly modifiable by a change in accounting standards. Civil-law thinking means to develop abstract principles regardless of single cases and to apply these abstract principles to the facts of the case by a process of subsuming. This method requires anticipating and solving of problems prior to their appearance, while common law systems react to the problems when they appear.

Impact of IFRS on Accounting Variables

Research on the impact of IFRS in Spanish companies is scarce. One of the reasons for this lack of interest may be the late adoption of interna-

5. (Van Tendeloo & Vanstraelen, 2005) a sample of private companies from EU countries (Belgium, Finland, France, Netherlands, Spain and the UK) and find that Big auditors constrain more the earnings management practices in countries with a high tax alignment (Belgium, Finland, France and Spain).

tional standards. To give an example, only one company presented in 2003 the financial statements under IFRS (AMADEUS). And most of non-listed companies, waited until last mandatory date on the 1st of January, 2008 (AMADEUS).

Callao, Jarne and Láinez (2007) find empirical evidence, using a very small sample of 26 firms (IBEX35), that the image of listed Spanish firms differs significantly when IFRS-based PGC is applied in the preparation of financial information. The effect of implementing the new PGC has been more significant for accounting variables and ratios related to the company's balance sheet. Current assets, liabilities, and equity have substantially varied when applying IFRS. Fair value method and changes in valuation and consolidation of the different variables have impacted these amounts. Fixed assets and inventories, on the other hand, have reflected a low and no significant change, since the valuation methods did not change. Income statement has also entailed large differences due to the treatment of revenues and expenses, especially extraordinary items. Figure 3 summarizes some of these changes.

Accrual	IFRS change	Impact
Current assets	<ul style="list-style-type: none"> • Application of fair value to financial instruments • Reclassification of accounts • Changes in the scope of consolidation 	High
Liabilities	<ul style="list-style-type: none"> • Changes in valuation of debts • Changes in the scope of consolidation • Deferred Tax liability effect 	High
Equity	<ul style="list-style-type: none"> • Direct adjustments • Indirect effect of adjustments to results 	High
Fixed assets	<ul style="list-style-type: none"> • Fair Value • Acquisition cost 	Low (most companies did not change to Fair value)
Inventories	<ul style="list-style-type: none"> • Cancellation of LIFO method 	Low (method not generally applied by Spanish firms)
Income statement	<ul style="list-style-type: none"> • Differences in the treatment of revenues and expenses (R&D expenses, asset impairment, etc.) 	High
Extraordinary income	<ul style="list-style-type: none"> • Reclassify certain extraordinary items under SAS as operating income under IFRS 	High

Figure 3. Level of impact of IFRS in accounting Variables.

Cash, solvency and indebtedness ratios, as well as the return on assets and return on equity, varied significantly as a result of the changes in the balance sheet and income statement. Financial analysis of Spanish firms after IFRS applications varies significantly and room for manipulation is large.

Impact of IFRS on Earnings Management (EM)

General belief of IFRS reduces EM comes from studies such as Barth et al (2008), where the authors find aggregate evidence across 21 countries of less EM. However they do not specify the results for each country and more over, they cannot be sure the findings are attributable to the change in the financial reporting system or to changes in firms' incentives and the economic environment.

A recent study by Callao and Jarne (2010) examines the impact of IFRS across 11 countries (Spain included) and gives country-individual results. The authors compare discretionary accruals on the period immediately before and after of IFRS implementation. Results showed that EM had intensified since the adoption of IFRS in Spain, as discretionary accruals have increased in the period following implementation. They studied separately long-term and current assets for more detailed conclusions and found an increase of long-term discretionary accruals in all countries except Italy, and a significant increase of current discretionary accruals in France, Spain and UK. In contrast, in Germany, the Netherlands and Portugal discretionary accounting practices decreased in terms of current accruals.

These results suggest that IFRS have actually encouraged discretionary accounting and opportunistic behaviour in some countries probably due to country specific characteristics and institutional and environmental conditions. Relationship between the accruals and institutional variables is negative for both periods, which implies that the level of investor protection and legal enforcement used in implementing the standards have helped to keep in check those manipulative practices. Another interesting result is that the countries where EM has increased the most are France and the UK. France traditionally regarded as a code-law based accounting system, and UK, as explained before, is by foundation a common-law based. This supports Callao et al (2007) results, suggestion that the source of legal system is not decisive for the impact of the IFRS on EM.

Academic convergence is found, however, in pointing out as determinant to reduce EM the existence of strong institutions and high legal enforcement, low ownership concentration and large capital markets that align

reporting incentives towards a required protection of investors. Accounting standards can limit a manager's ability to distort reported earnings, but the extent to which accounting rules influence reported earnings and reduce EM depends on how well these rules are enforced. Countries with strong outsider protection are expected to enact and enforce accounting and securities laws that limit the manipulation of accounting information reported to outsiders. How far this discretion is used depends not only on legal institutions, but also on firm-specific characteristics (Leuz, Nanda, & Wysocki, 2003; Callao & Jarne, 2010).

Countries that lack of all of those traits might fight accounting manipulation with tighter and context-based rules. The entrance of IFRS has broken that balance, and by switching from custom-made standards to others more flexible and subjective has open a gap for opportunistic behaviours. We understand that application of any accounting standard involves considerable judgment and the use of private information. However IFRS provides managers with greater room for discretion than previous Spanish «PGC». IFRS endows greater subjectivity by the application of certain criteria such as fair value and the lower level of requirements related to the financial statements presentation format. Examples of options in IFRS are the choice of capitalisation or expensing for interest costs on assets; choice of cost or fair value measurement for classes of property, plant and equipment or for some types of intangible assets; choice of content of statement of changes in equity, no format requirements for balance sheet or income statement, and so on. Some of the most relevant differences between IFRS and PGC regarding higher room for EM are summarized in Annex A.

In addition to the subjectivity that all those choices bring to the financial reporting, fair value measurement increase volatility in some accounting variables. This valuation method involves reporting assets and liabilities on the balance sheet at a market or model-determined value and recognizing changes in value as gains or losses in the income statement or through equity. This method increases earnings volatility and may affect the market's perception of risk. Thus, managers may have motivations for earnings smoothing—reduce their volatility—and thus signal lower risk to the market. This involves linking incentive and opportunity in the same context.

Some researchers have made an effort to disentangle the effect of standards and institutional factors on earnings quality comparing a powerful and high quality rules-based system as the US GAAP⁶ (US domestic

6. For years, US GAAP has been considered as THE set of standards to ensure high quality financial statements, not only by Americans but also in other countries (VanDerMeulen, Gaeremynck, & Willekens, 2007).

standards) with IFRS in the same contextual framework. German companies are allowed to present their financial statements in IFRS, US GAAP or German GAAP indistinctly, providing researchers with the perfect set up for this type of studies. Empirical results show that while overall quality of the financial statements is very comparable in both sets of standards (Van-DerMeulen, Gaeremynck, & Willekens, 2007), manipulation of earnings is significantly lower under US GAAP than under German GAAP and IFRS where is roughly the same (Goncharov & Zimmermann, 2008).

A recent study by Ding et al (2007) brings a new approach to analyze how standards should be designed in country-specific framework. They measure the difference between IFRS and domestic standards from two dimensions; absence and divergence. *Absence* measures the number of IFRS rules absent in the domestic standard, and *divergence* measures the number of rules regarding the same accounting issue that differ in domestic standard with respect IFRS. The authors find that a higher absence level is associated with more EM, suggesting that expanding the coverage of accounting issues by domestic standard is essential to improve transparency and to curb earnings management. Meanwhile divergence level has no relation to EM, meaning that the difference may lay on the fact that domestic standards are better tailored to the needs of local legal and business environments. Absence of IFRS rules in domestic standards can then be the key to understand the relationship of IFRS and EM. Ding et al. found that countries with higher level of absence⁷ have less developed equity markets and higher ownership concentration (e.g. Spain). This new findings open a new perspective to confront earnings quality improvement and warrant further research.

Conclusion and further actions

From the moment it is clear the need to harmonize accounting standards to allow cross country comparisons. There has been an arduous debate about the higher reporting quality of principle-based versus rules-based standards. Although the lack of empirical convergence, principles-based standards have won the battle as IFRS is being implemented in many countries since the beginning of this century. This victory, however, seems to be more related to its adaptability to different legal and regulatory frameworks than to any improvement on its reporting quality.

7. Ding et al (2007) examine 30 countries, Spain is position seventh after Greece, Austria, Denmark, Malaysia, Thailand and Portugal, with 28 out of 111 IFRS rules not included in domestic standard «PGC».

Throughout this article we have analyzed the impact of adopting IFRS on earnings quality across different countries and more specifically within Spain. The overall conclusion is that institutional factors and legal enforcement are sizeable determinants for the quality of financial reporting and a powerful tool for curbing opportunistic behaviors. EM occurs because managers have (hidden) incentives to mislead financial information in order to meet certain earnings thresholds. Countries with strong equity markets and high investor protection limit insiders' ability to acquire private control benefits, which reduces their incentives to mask firm performance. Minimizing these incentives might be the most effective approach to fight EM.

The scant research on Spanish companies' accounting manipulation provides evidence of more opportunistic behavior in accrual based EM after adoption of IFRS. We find significant increase of current and long term discretionary accruals in Spanish⁸ financial statements and a negative relationship between accruals and institutional variables supporting the environmental relevance. The main explanation can be found on the fact that IFRS is more flexible and contains higher subjectivity than rules-tight PGC when applying accounting standards. However, to have any conclusion on the final effect of principles-based IFRS on EM we should not overlook the effect of this swift on the transaction-based EM. As some studies have suggested, we might expect a reduction of real activity EM when implementing a principle-based system, changing the sign of total EM variation. Unfortunately no research in that direction is been conducted, as far as we know.

A new approach to analyze standards effectiveness might have emerged by making a distinction between incorporating new standards (due to a void in domestic regulation) versus changes on the existing domestic standards. Although more research is needed in this direction, we find positive relationship between changes in already existing standards and EM, probably due to the fact that the domestic standards were designed accordingly to the specificities of the country. While adding new standards that overlay a domestic regulation gap, appears to be more effective in curbing EM.

Ultimately, this paper contributes to the understanding that accounting standards disregarding changes in institutional framework and legal enforcement will not have the pursued effect of curbing earnings manipulation. Sharing rules is not a sufficient condition to create a common business language, and that management incentives and national institutional factors

8. This study of Callao and Jarne (2010) finds an increase of current discretionary accruals in Spain, France and UK; a reduction in Germany, The Netherlands and Portugal; and an increase in long-term discretionary accruals in all countries.

play an important role in framing financial reporting characteristics. The suggestion is that the next step in the process of harmonization and improvement of earnings and reporting quality is the harmonization of incentives and institutional factors across countries and regions.

ANNEX Main differences between IFRS and PGC (1990) regarding higher impact on EM

Issue	Under Spanish «PGC-1990»	IFRS	Room for EM
Goodwill	Amortized over the useful life of the investment, which may not be exceed 20 years	Not to be amortized, instead the acquirer shall test it for impairment annually.	High (very subjective in IFRS)
Financial assets	Measured at the lower of acquisition cost and market value Financial liabilities are measured at repayment value	IAS 39: <i>Measured at their fair values, (except loans and receivables, held-to-maturity investments and some investments in equity)</i> Financial liabilities measured at amortized cost using the <i>effective interest method</i> .	High (very subjective in IFRS and higher difficulty in calculating the effective interest method instead of straightline method)
Recognition of Finance lease	All leased assets are depreciated over their useful lives.	IAS 17: The depreciation of leased assets should be over the shorter of useful life and the term of the lease in cases where subsequent ownership of the asset is not guaranteed.	High (higher subjectivity in depreciation choice)
R&D expenditure	Recognized as an intangible asset if certain conditions are found.	IAS 38: Research expenditure shall be recognized as expense when they are incurred and intangible assets do not arise.	High (more vague conditions in IFRS)

The income statement	Classification of expenses based on their nature and <i>distinguishes between ordinary and extraordinary income and expenses.</i>	IAS 1: <i>No distinction between extraordinary and ordinary income and expenses.</i>	High (more vague in IFRS)
Income tax	The rule requires an entity to account for deferred tax using the <i>income statement liability method.</i> A deferred tax asset is recognized when future recovery is likely (within a <i>maximum period of 10 years</i>). An entity <i>cannot compensate</i> deferred tax assets and deferred tax liabilities.	IAS 12: This requires an entity to account for deferred tax using the <i>balance sheet liability method.</i> A deferred tax asset should be recognized for deductible temporary differences if likely to compensate (<i>no temporal limit</i>). An entity <i>shall compensate</i> deferred tax assets and deferred tax liabilities of the same taxable entity if it complies with certain conditions.	Higher (more vague in IFRS)
Valuation of property, plant and equipment (PPE)	Valued at acquisition cost.	IAS 16 and IAS 38: Valued at acquisition cost, or fair value.	High (higher subjectivity in IFRS)

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