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Effects of IFRS Adoption on Tax-induced Incentives for Financial Earnings Management: Evidence from Greece ☆

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Abstract

We investigate whether the adoption of International Financial Reporting Standards (IFRS) in Greece affected tax-induced incentives for financial earnings management. Prior to the implementation of IFRS, there were powerful incentives for firms facing higher tax pressure to restrict (exacerbate) upward (downward) financial earnings management due to direct tax implications. IFRS adoption reduced book–tax conformity, thereby releasing financial income from tax implications. As expected, we find that tax pressure is a significant negative determinant of discretionary accruals in the pre-IFRS period. However, this effect dissipates under the new IFRS regime.

JEL classification: M41; H26
Keywords: Book–tax conformity; IFRS adoption; Earnings management; Greece

1. Introduction

Using a sample of Greek firms, we study the potential implications of the adoption of International Financial Reporting Standards (IFRS henceforth) for book–tax conformity and its concomitant effects on tax-induced managerial opportunism. Greece provides an interesting research setting because high book–tax conformity and close links between

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financial income and taxable income prevailed prior to IFRS enactment. The strong interconnectedness between financial and tax reporting amplifies tax-induced incentives to restrict (exacerbate) upward (downward) financial earnings management for tax purposes. Tax-induced incentives are further encouraged by the paucity of analyst coverage (Chang, Khanna, & Palepu, 2000) and the underdevelopment of the Greek capital market relative to other European jurisdictions (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997). The lack of analysts' benchmarks to meet or beat, the concentrated family-ownership of Greek firms (La Porta et al., 1997; Papas, 1992), and the low reputation costs for managers promote tax goals relative to other managerial targets.[1] In addition, corporate costs of financial income manipulation are not severe due to poor monitoring mechanisms at the institutional level. Weak legal enforcement, low regulatory quality and inadequate shareholder protection are prevalent attributes of the Greek setting (Karampinis & Hevas, 2011).

High book–tax conformity renders upward financial earnings management a particularly costly activity; even artificially increased financial income entails tax implications. In a similar vein, high book–tax conformity renders downward financial earnings management a potentially attractive vehicle to reduce taxes. However, these incentives are not expected to be equal across firms. On the contrary, we predict that their intensity varies depending on a firm's tax pressure. We use the term "tax pressure" to refer to a firm's ability to retain low taxes relative to its operating performance. Firms facing higher tax pressure exploit less efficiently the provisions stipulated in Greek tax law (e.g., investments in profitable associates, tax loss carryforwards, tax credits and untaxed reserves, domiciling in areas with lower tax rates) and incur increased tax outlays. Therefore, these firms may have greater incentives to restrict (exacerbate) upward (downward) financial earnings management. In these respects, the first prediction of this paper is that tax pressure constitutes a significant negative economic determinant of financial earnings management under a high book–tax conformity regime such as the pre-IFRS period in Greece.

The adoption of IFRS caused an inevitable change in the interconnectedness between financial accounting and tax accounting in Greece. Because IFRS is independent of tax considerations (Hung & Subramanyam, 2007), the tax implications of financial income weakened considerably in the post-IFRS period. We argue that such relaxation in book–tax conformity renders upward financial earnings management less costly and downward earnings management less attractive for tax purposes. Therefore, the second prediction of this paper is that the aforementioned effect of tax pressure declines in the post-IFRS period.

To assess these predictions, we gauge financial earnings management via abnormal discretionary accruals estimated using a Modified Jones model (Dechow, Sloan, & Sweeney, 1995) that includes return on assets (ROA) to control for operating performance (Kothari, Leone, & Wasley, 2005). In addition, we consider positive and negative discretionary accruals separately. Following prior research (e.g., Gupta & Newberry, 1997; Othman & Zeghal, 2006; Stickney & McGee, 1982; Zimmerman, 1983), we use each firm's average effective tax rate (ETR) to measure tax pressure. In particular, we employ the ratio of the current tax expense to operating cash flows (ETRCFO) as an indicator of tax

[1] Interestingly, Wang (2006), using a U.S. sample, finds that family ownership is negatively related to earnings management activities. However, the opposite appears to hold in jurisdictions characterized by weak investor protection, low-quality GAAPs and private channels of information (Fan & Wong, 2002).