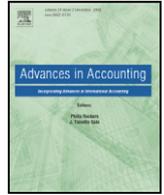




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## Improving earnings quality: The effect of reporting incentives and accounting standards

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### ABSTRACT

We investigate the different effects on earnings quality of accounting standards and reporting incentives for Germany over the period 1994 to 2005. To this end, we control for reporting incentives at the firm level, instead of the country level, by using the timing of voluntary IFRS adoption as a proxy for reporting incentives. We then include reporting incentives in an analysis of earnings management and information asymmetry. Contrary to common expectation, we find that IFRS reporting potentially decreases earnings quality on average; but also that reporting incentives appear to have lower effects on earnings quality in IFRS statements than in GGAAP statements. Thus, IFRS may lead to more homogenous earnings quality across firms.

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### 1. Introduction

Much attention in current accounting research is given to the effect of accounting standards on earnings quality. However, earnings quality is not likely to be determined by accounting standards alone, because accounting standards cannot address the level of detail that is required in business, they lag innovations in practice, and their implementation generally requires judgment (e. g., Ball, Kothari, & Robin, 2000; Burgstahler, Hail, & Leuz, 2006). Consequently, even within the same accounting environment, similar companies can use discretionary items to report financial earnings of significantly different quality to the public.

We address this issue in the setting of the German capital market, where the International Financial Reporting Standards (IFRS) have largely replaced the German Generally Accepted Accounting Principles (GGAAP) over the last decade.<sup>2</sup> Specifically, we ask whether the results of extant earnings quality studies on the German capital market (e.g., Gassen & Sellhorn, 2006; Leuz, 2003; Leuz & Verrecchia, 2000; van Tendeloo & Vanstraelen, 2005) – where reporting incentives are not controlled for – are comparable to the results that are obtained when reporting incentives are introduced to the model. We thereby focus on earnings management

and information asymmetry, which arguably are the two most important earnings quality characteristics.

Germany provides a valuable “natural experiment” for research in the area of reporting incentives. Starting in 1998 the German commercial code allowed listed companies to choose which internationally accepted accounting standards to use in preparing their consolidated financial statements. This resulted in the unique situation where different accounting standards, particularly IFRS and GGAAP, coexisted in Germany's capital market in the late 1990s and the beginning of the new millennium (e. g., Leuz, 2003). German companies were therefore given a considerable period of time in which they could voluntarily comply with IFRS in preparing their consolidated financial statements. Considering the different origins of IFRS and GGAAP, the decision to switch to IFRS signals that management is incentivized to comply with shareholder-orientated, fair value-based accounting rules, instead of the creditor-oriented accounting rules of GGAAP. Given the particular historical development of the German accounting environment as a whole, a firm's costs of this signal depend on the point in time at which IFRS was first adopted. Our research thus builds on the assumption that the timing of IFRS adoption can be used as a proxy for a company's reporting incentives.

In our analysis, we observe that IFRS on average either has no significant effect on earnings quality or even decreases earnings quality relative to GGAAP. Moreover, we find that reporting incentives have an effect on earnings quality in both GGAAP and IFRS. Most importantly, we show that earnings quality in IFRS reporting is less affected by reporting incentives than in GGAAP and thus that IFRS might lead to a more homogenous earnings quality across firms.

We extend prior research in three ways. First, we contribute to the discussion about how reporting incentives influence on earnings quality. Prior research shows that institutional differences across

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<sup>2</sup> The IFRS include the International Accounting Standards (IAS) and the standards of the International Accounting Standards Board (IASB), as well as the interpretations of all standards by the Standing Interpretations Committee (SIC) and the International Financial Reporting Interpretations Committee (IFRIC). In order to keep our line of arguments simple, we use IFRS to subsume all of the above.

countries influence reporting quality. However, in contrast to the majority of prior studies, we use a sample of firms that are subject to the exact same institutional framework and legislation. We therefore are able to investigate at the firm level whether reporting incentives influence earnings quality. Second, we provide theoretical discussion and empirical evidence that the timing of the adoption of new accounting standards can in fact be used to proxy for differences in reporting incentives, which presumably in turn lead to differences in earnings quality. Since IFRS adoption was optional in many European Union (EU) member states for more than a decade, the approach introduced below enables researchers in other EU member states to include reporting incentives in their earnings quality analyses as well. Third, we utilize the given setting to show the effect of reporting incentives on two selected measures of earnings quality in Germany and to compare these to the effect that derives from accounting standards alone. We thereby focus on the two most important earnings quality measures, namely earnings management and information asymmetry. In sum, we contribute to the ongoing discussions about the effects of accounting standards and reporting incentives on earnings quality.

## 2. Development of accounting standards in Germany

GGAAP are generally considered to be among the more extreme examples of the continental model of code law accounting (Joos & Lang, 1994). The main objectives of GGAAP are to preserve equity and to protect creditors. Toward these ends, the GGAAP standards offer opportunities to create hidden reserves and oblige companies to report income carefully. GGAAP therefore tend to result in understated earnings (Harris, Lang, & Möller, 1994).

The German accounting system distinguishes between unconsolidated and consolidated financial statements. Unconsolidated financial statements are used as the basis for a company's dividend decision, and must be reported in GGAAP until today. They are closely related to the German tax statement via strong book-tax conformity and thus also impact on the tax burden of a company. Consolidated financial statements are derived based on the unconsolidated financial statements for the entire corporate group. In contrast to the unconsolidated financial statements, consolidated financial statements serve purely informational purposes. Even though they are technically derived from the unconsolidated financial statements of the respective group, discretionary accounting items are often revaluated according to specific group needs with regard to capital markets. In the German accounting system, consolidated financial statements have no direct implications for dividend policy and the level of formal book-tax conformity is low. Consolidated tax statements do not exist.

During the 1990s, German companies became more and more dependent on capital from international shareholders and therefore faced an increasing need to adopt reporting standards accepted by the international capital markets. However, until 1998, the German commercial code accepted neither unconsolidated financial statements nor consolidated financial statements if they were not prepared according to GGAAP. As a result, German companies adopted strategies to simultaneously meet their obligations under GGAAP and the requirements of the international capital markets. Two strategies were common. First, companies used available accounting discretion to prepare GGAAP financial statements that were as close as possible to statements prepared under internationally accepted standards (dual reporting). Second, firms prepared two separate sets of financial statements for the same year, one according to GGAAP and one according to internationally accepted standards (parallel reporting).

In reaction to the rapid developments of accounting standards around the world and the increasing dependence of German

companies on international capital markets, the German Capital Raising Facilitation Act (KapAEG) was introduced in April 1998.<sup>3</sup> It allowed listed companies to prepare consolidated financial statements according to any set of internationally accepted accounting standards instead of GGAAP. The two most relevant internationally accepted accounting standards at that time were IFRS and the United States Generally Accepted Accounting Principles (USGAAP). Consequently, the most important effect of the KapAEG was that German companies now had the opportunity to compete for equity capital internationally, without the costs of dual or parallel reporting. However, there was substantial political debate about whether IFRS or another accounting regime (for instance, USGAAP) should be made mandatory for all of the EU in the long run, which posed considerable uncertainty for German companies interested in converting to an internationally accepted accounting standard.

In July 2002 this uncertainty was resolved with EU Order 1606/2002, which made adoption of IFRS mandatory for all companies listed on capital markets within the EU. This Order declared that all consolidated financial statements for firm years starting in 2005 had to be prepared according to IFRS.<sup>4</sup> Thus, with the uncertainty resolved about the reporting standards that would become mandatory within the EU, companies that were willing to adopt international accounting standards but unwilling to bear the costs of choosing a standard that might not prevail could safely adopt IFRS as of July 2002.

## 3. Previous research

Earnings quality generally refers to the quality of the earnings reported on the financial statements, as opposed to the broader concept of reporting quality, because earnings is the summary measure on which stakeholders of listed companies mainly focus. With regard to earnings quality, the most frequently investigated characteristics are earnings management and information asymmetry. Most recent research seeks to connect these earnings quality characteristics to reporting incentives. Below we therefore discuss in turn the results of existing work on reporting incentives, earnings management, and information asymmetry.

### 3.1. Reporting incentives

Recently, the effect of reporting incentives on earnings quality has gained considerable attention, with studies such as Ball, Robin, and Wu (2003), Lang, Raedy, and Wilson (2006), Burgstahler et al. (2006), and Bushman and Piotroski (2006).

Ball et al. (2003), Lang et al. (2006), and Bushman and Piotroski (2006) use institutional differences in factors such as legal system, security laws, political economy, and enforcement of accounting standards across countries to proxy for the reporting incentives of a particular group of companies for which the accounting standards chosen are the same or similar. Burgstahler et al. (2006) include capital market pressure in their analysis by comparing private and public firms in different EU member states. They argue that capital market pressure increases the earnings quality of the publicly listed firms because companies that provide low quality earnings are either punished by the capital market or screened out during the process of going public.

Overall, these studies find that reporting incentives strongly affect the de facto application of given accounting standards and hence that differences in reporting incentives, ceteris paribus, lead to differences in earnings quality. Despite these findings, however, reporting

<sup>3</sup> In 1978, the EU adopted the 4th EU Directive to harmonize unconsolidated statements among its member states. In 1983, the 7th EU Directive was introduced to harmonize consolidated statements. Both Directives were implemented in the German accounting system via the Accounting Directives Act (BiRiLiG), but their impact on the reporting regime in Germany was only minor.

<sup>4</sup> In contrast to a Directive, an EU Order is binding law in all member states of the EU.

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