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Earnings management under German GAAP versus IFRS

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Abstract

This paper addresses the question whether voluntary adoption of International Financial Reporting Standards (IFRS) is associated with lower earnings management. Ball et al. (Journal of Accounting and Economics, 36(1-3), pp. 235-270, [2003](#)) argue that adopting high quality standards might be a necessary condition for high quality information, but not necessarily a sufficient one. In Germany, a code-law country with low investor protection rights, a relatively large number of companies have chosen to voluntarily adopt IFRS. We investigate whether companies that have adopted IFRS have adopted IFRS to German GAAP, or whether they have adopted IFRS to German GAAP, while still reporting to German GAAP. Our sample, consisting of 1,000 companies, is divided into two groups: companies that have adopted IFRS to German GAAP, and companies that have adopted IFRS to German GAAP, while still reporting to German GAAP. These findings contribute to the current debate on whether high quality standards are

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sufficient and effective in countries with weak investor protection rights. They indicate that voluntary adopters of IFRS in Germany cannot be associated with lower earnings management.

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Notes

¹For convenience we use the term Big 4 auditor to identify the large international audit firm networks. Some of the studies we refer to were conducted before the mergers resulted into a reduction to four international audit networks.

²Conservatism is here referred to as pervasive conservatism or balance sheet conservatism and has to be distinguished from earnings conservatism or asymmetric timeliness. Pervasive conservatism refers to a consistent understatement of equity. Earnings conservatism refers to bad news being more timely reflected in earnings than good news.

³Tax-free realization of capital gains is a common feature in many countries. It is often used as a means to encourage investment and reduce the tax burden on capital income. Depreciation is a non-deductible expense for tax purposes, which reduces the tax base and thus reduces the tax liability. Commercially, depreciation is a non-deductible expense for tax purposes, which reduces the tax base and thus reduces the tax liability.

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‘special item with equity element’ the depreciated asset can be represented in the balance sheet with its ‘real commercial book value’. Companies are however not obliged to report tax induced higher depreciations this way. According to a 1987 study, less than one-quarter of the German companies actually do so (Haller, [1992](#)).

⁴First time applications of IFRS could not have its full effect yet or result in substantial changes in the computations of earnings causing high abnormal accruals that would incorrectly be attributed to earnings management.

⁵Average adjusted R^2 is 30% and ranges from 0.2 to 77%.

⁶While most earnings management studies assume earnings are managed for opportunistic reasons, the exercised discretion can also be used to signal private information and thus reduce information asymmetry (e.g. Subramanyam, [1996](#)). However, because accounting systems likely underreact to economic shocks, using accruals to signal firm performance results on average in a less negative (and in specific cases even positive) correlation with cash flows (Leuz et al., [2003](#)).

⁷This variable appears to be highly significant in the IFRS model ($p < 0.01$).

⁸Non-parametric tests (Wilcoxon Mann-Whitney test) yield the same result regarding the discretionary accruals but indicate a significant ($p = 0.046$ two-tailed) difference between the average total reported income-increasing and income-decreasing accruals.

⁹Non-parametric tests (Wilcoxon Mann-Whitney test) revealed qualitatively similar results.

¹⁰As mentioned earlier, these hidden reserves can be created by recognizing excessive depreciation of assets, building up unjustified provisions or setting aside certain profits in tax-free reserves. Depreciation is already accounted for in our previous accruals

measured that certain p a limitations, all of the e filtered out bec rves.

¹¹Firm her IFRS or

US GAAP

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