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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 prior to 2005. We investigate whether German companies that have adopted IFRS engage significantly less in earnings management compared to German companies reporting under German generally accepted accounting principles (GAAP), while controlling for other differences in earnings management incentives. Our sample, consisting of German listed companies, contains 636 firm-year observations relating to the period 1999–2001. Our results suggest that IFRS-adopters do not present different earnings management behavior compared to companies reporting under German GAAP.

These findings contribute to the current debate on whether high quality standards are 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

[1]For 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.

[2]Conservatism 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.

[3]Tax-free reserves or ‘special items with an equity element’ are used for instance for realized capital gains on assets which are left to the company to purchase new assets in the near future. They are charged against income when created and treated as income when they are released. This special item can also be used for excessive depreciations, which have to be included in the commercial accounts and thus reduce

commercial income in order for them to be tax deductible, but when reported as a '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).

[4]First 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.

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

[6]While 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).

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

[8]Non-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.

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

[10]As 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 measure. After investigating some individual financial statements, it appeared that certain provisions were sometimes classified as other liabilities. Due to data limitations, all of the tax-free reserves or 'Sonderposten mit rücklageanteil' could not be filtered out because they were included in a larger category, comprising other reserves.

[11]Firms that were listed on the German New Market had to report under either IFRS or US GAAP.