Accounting quality and the adoption of IASB standards: portuguese evidence.

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Accounting quality and the adoption of IASB standards - Portuguese evidence

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ABSTRACT

Through rule 1606/2002 by the European Commission, Portuguese listed firms were required to adop
preparation and presentation of consolidated accounts for the periods beginning on or after 2005. IAS
developed in environments where accounting practices are especially directed at the private sector, re
unaffected by taxation requirements and capital is traditionally raised in public markets. However, in
reporting is closely related to tax reporting and banks play a key role in providing finance and inside a
investigate whether adopting IASB standards is associated with higher earnings quality and higher val
compare the earnings quality and value relevance of accounting data of 34 Portuguese listed firms bef

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(2004-2005) the adoption of IASB standards. We find that firms, during the period when they adopt IAS smooth earnings than those firms in periods when they adopted national accounting standards, which improvement in earnings quality. However, we also find that the value relevance of accounting inform adoption of IASB standards.

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1 INTRODUCTION

Portuguese listed firms are required to adopt International Accounting Standards Board (IASB) standa and presentation of consolidated accounts for periods beginning on or after 1 of January 2005 (Rule 16 Commission). Until 2005, Portuguese listed firms were required to apply local standards (*Plano Oficia Directrizes Contabilísticas*).

IASB standards are developed in environments where accounting practices are especially directed at t reporting rules are largely unaffected by taxation requirements and capital is traditionally raised in pu standards are clearly influenced by common-law countries, like the United States of America (USA) an (UK). However, Portuguese institutional and legal environments are different and these differences af accounting system.

Several studies show significant differences in ownership structures between code-law and common-l Lang (2002) find that firms from common-law countries are more likely to be widely held, while firms are family controlled. Faccio and Lang (2002) also find that, in countries like Portugal, the state contro proportion of firms, especially the largest, than in UK or USA. If we consider the state as a single entity a concentrated ownership. In these countries, agents of stakeholders tend to be informed by private a the need for timely public disclosure is less important. In a widely-dispersed share ownership, manag interests may diverge in important ways, raising the problem of asymmetric information. This problem financial reporting and other forms of timely public disclosure.

The difference in ownership structures can be attributed to weak regulation in code-law countries and common-law countries. La Porta *et al.* (1997, 1998) show that common law systems, like UK or USA sys minority investor protection. On the contrary, civil law systems like the Portuguese have weak protecti extent to which a country's laws protect investor rights and the extent to which those laws are enforced determinants of the ways in which corporate governance evolves in that country. Weak legal protectio shareholders can create opportunities for managerial abuses.

The design of accounting systems can also be affected by the orientation of a country's financial syste be classified as debt-based (such as Portugal) or market-based (such as UK or USA) (DEMIRGUEKUN equity-based financial systems, the preference for equity ownership and the concern with the maximiz value tend to lead to a greater importance of accounting quality.

Finally, Portuguese financial reporting is closely related to tax reporting, which encourages income sm IASB standards are separate from tax laws.

Previous studies on the quality of accounting standards provide mixed evidence. Barth *et al.* (2005) an that the adoption of IASB standards increases accounting quality. Based on a large sample of firms fro Barth *et al.* (2005) find that, after IAS adoption, firms evidence less earnings management, more timely more value relevance of accounting data than firms that do not adopt. Bartov *et al.* (2004) also find tha firms, accounting earnings based on international accounting standards are more value relevant than accounting standards. However, Eccher and Healey (2003) find that accounting data based on internat standards are not more value relevant than those based on Chinese accounting standards. Hung and S

identify the sources of reconciling items between German accounting standards and international acc
find that the adjustments to net income are not value relevant.

The objective of this study is to compare the accounting quality (earnings quality and value relevance
firms before and after the adoption of IASB standards.

First, we investigate if earnings quality increased with the adoption of IASB standards. Similar to Barth
different measures of earnings quality: the variability of the change in net income scaled by total asset
variability of the change in net income to the variability of the change in operating cash flows; the Spea
between accruals and cash flows; the coefficient of small positive income and the coefficient of large n

Second, we investigate the value relevance of accounting data. We regress the market price of shares o
value of equity in order to estimate R^2.

Our results seem to suggest that firms, during the period when they adopt IASB standards, report less s
those firms in periods when they adopted national accounting standards, which seems to suggest an i
quality. However, we also find that the value relevance of accounting information decreases with the a
standards. This contradiction may be due to differences in our samples (we have fewer observations f
than for Portuguese accounting standards adoption) or because the period of IFRS/IAS adoption is a t
quality of information may be lower than in future periods).

The structure of the paper is as follows. Section 2 defines accounting quality and identifies some meas
quality used in previous studies. Section 2 also defines earnings quality and value relevance and revis
Section 3 provides a description of the sample, hypotheses and variables. Section 4 presents empirica
summarizes and concludes.

2 ACCOUNTING QUALITY

The objective of financial reporting is to provide information about financial position, performance an
position of an entity that is useful in making economic decisions for a wide range of users, such as inv
lenders, suppliers, customers, government and the public in general.

The quality of financial reporting has been receiving greater attention, especially after recent accounti
increased attention, the term accounting quality is vague and difficult to define.

The objective of IASB is to develop, in the public interest, a single set of high quality accounting standa
transparent and comparable information in financial statements. However, IASB does not present a de

Penman (2002) considers that accounting quality should be discussed in terms of shareholders' intere
of those interests. Penman's notion of accounting quality is based on the usefulness of information fo
the use of the modified shareholder perspective. Under this perspective, accounting should promote s
also consider the public interest.

Despite the inexistence of a clear definition of accounting quality, several studies use measures that a
accounting quality, for example, earnings management, timely loss recognition and value relevance (E
paper, we use earnings quality and value relevance as proxies of accounting quality.

2.1 Earnings quality

Penman (2002) considers that earnings quality is an important feature of financial reporting since inve
earnings.

Despite the importance of earnings for stakeholders, the term earnings quality is also vague and has d
Some authors relate earnings quality to the accurate representation of underlying economic transactio

interpretation focuses on persistence of earnings, where earnings of higher quality are sustainable and
more general interpretation of the persistence idea is suggested by tying earnings quality with predict
earnings of higher quality are a good indicator of future earnings. Finally, some authors use the term i
accounting conservatism.

Cohen (2003) defines earnings quality as the degree to which accounting figures more accurately repr
economic fundamentals of the firm and the extent to which they map into operating cash flow realizat
(2003) view earnings quality as the extent to which reported earnings faithfully represent Hicksian inc
that can be consumed consistent with the maintenance of wealth). Chan *et al.* (2004) consider earnings
which reported income reflects operating fundamentals. Yee (2006) considers that earnings quality ha
fundamental attribute and second as a financial reporting attribute. Fundamental earnings are the acc
measure that gauges a firm's ability to make future dividend payments. Reported earnings are the imp
fundamental earnings a firm announces. Therefore, earnings quality refers to how quickly and precise
reveal fundamental earnings.

Kirschenheiter and Melumad (2004) consider that high quality earnings are more informative and clo
of the firm. Revsine *et al.* (1999) consider that earnings are of higher quality when they are sustainable
(2002) define high quality earnings as sustainable earnings, that is, earnings that are a good indicator

White *et al.* (2003) define earnings quality as the degree of conservatism in a firm's reported earnings.
(2002) also link earnings quality with conservatism.

Previous studies about earnings quality have used different measures to approach earnings quality. F
Vicent (2003) classify the earnings quality constructs in four categories: persistence, variability and pre
SCHIPPER; VINCENT, 2003; RICHARDSON *et al.*, 2005); relations among cash, accruals and income (JO
al., 1995; DeANGELO, 1986; DECHOW; DICHEV, 2002); qualitative concepts in the FASB's conceptual fr
implementation decisions (incentives and expertise of preparers and auditors) (KIRSCHENHEITER; M

Similar to Barth *et al.* (2005), we use several measures of earnings management.

First, we use the variability of the change in net income scaled by total assets (LEUZ *et al.*, 2003; BARTH

$$\Delta INITA = \frac{NIt}{TAt} - \frac{NIt-1}{TAt-1} \qquad (1)$$

Where: NI is net income and year-end TA total assets. A higher variance is associated with a lower leve

Second, we use the ratio of the variability of the change in net income to the variability of the change i

$$\frac{\Delta NI}{\Delta OCF} = \frac{NIt - NIt-1}{OCF - OCF - 1} \qquad (2)$$

Where: NI is net income and OCF cash flows from operations. If firms use accruals to manage earning
change in net income should be lower than that of operating cash flows.

Third, we use the Spearman correlation between accruals (hereafter ACC) and cash flows from operati
accruals and cash flows from operations are negatively correlated.

Fourth, we test if firms manage earnings towards small positive earnings (BURGSTAHLER; DICHEV, 19
BARTH et al., 2005). The measure is the coefficient on small positive net income (SPOS) in the followin

$$POST(1,0) = \alpha_0 + \alpha_1 SIZE_{it} + \alpha_2 GROWTH_{it} + \alpha_3 EISSUE_{it} + \alpha_4 LEV_{it} + \\ \alpha_5 DISSUE_{it} + \alpha_6 TURN_{it} + \alpha_7 OCF_{it} + \alpha_8 POST_{it} + \varepsilon_{it}$$

Where: POST assumes the value 1 if the firm adopt IASB standards and 0 otherwise; SIZE is the natural value at the year end; GROWTH is percentage change in sales; EISSUE is percentage change in commo liabilities at the year end divided by the book value of equity at the year end; DISSUE is percentage ch TURN is sales scaled by total assets at the year end; OCF is cash flows from operations and SPOS is an equals 1 if net income scaled by total assets is between 0 and 0,01.

Finally, we test timely loss recognition. Following Lang et al. (2003, 2005) and Barth et al. (2005), we m recognition as the coefficient on the percentage of large negative net income (LNEG) in the following r

$$POST(1,0) = \alpha_0 + \alpha_1 SIZE_{it} + \alpha_2 GROWTH_{it} + \alpha_3 EISSUE_{it} + \alpha_4 LEV_{it} +$$
$$\alpha_5 DISSUE_{it} + \alpha_6 TURN_{it} + \alpha_7 CF_{it} + \alpha_8 LNEG_{it} + \varepsilon_{it}$$

Where: POST equals 1 if the firm adopts IASB standards and 0 otherwise; SIZE is the natural logarithm year end; GROWTH is percentage change in sales; EISSUE is percentage change in common stock; LEV end divided by the book value of equity at year end; DISSUE is percentage change in total liabilities; T total assets at year end; OCF is cash flows from operations and LNEG is an indicator variable that equa by total assets is less than -0.20.

2.2 Value relevance

Ball and Brown (1968) were the first to report that stock prices react to the information disclosed in fin al. (1993) were the first to use the term value relevance with the meaning of how well accounting data by equity investors. Since then, several studies have investigated the price-earnings relation by using

Following Lang et al. (2003, 2005), we regress the market price of shares, as of six months after year en book value of equity per share (hereafter BVEPS) and net income per share (hereafter NIPS) in order t period that firms adopt international accounting standards and for the period that firms adopted Portu standards:

$$PRICE_{it} = \alpha_0 + \alpha_1 BVEPS_{it} + \alpha_2 NIPS_{it} + \varepsilon_{it} \qquad (5)$$

As the cross-sectional correlation in our sample is not very strong, we decided not to consider Barth's (BARTH et al., 2005, 2008).

3 RESEARCH DESIGN

In this section, we describe the sample selection and research design.

3.1 Sample

Our sample consists of 34 Portuguese listed firms that prepared and presented consolidated accounts in 2005. We consider the period between 1995 and 2004 (Portuguese GAAP adoption) and 20042005 (I our sample includes only one country and due to small sample size, we did not use a matching sampl al. (2005).

3.2 Hypothesis

The objective of this study is to compare the accounting quality (earnings quality and value relevance firms before and after the adoption of IASB standards.

First, we investigate if earnings quality increased with the adoption of IASB standards. Therefore, our f with earnings smoothing. Since Portugal is a code-law country, we expect that earnings smoothing is r

firms adopt national standards than when firms adopt IASB standards. Leuz *et al.* (2003) find that earni
pronounced in non-common law countries. This leads to our first hypothesis:

H1: We expect that earnings smoothing is more pronounced before IASB standard adoption than after IASI

Our second prediction is related to the value relevance of accounting data under national and internal
standards. Alford *et al.* (1993) find that the association between earnings and stock returns is stronger i
is traditionally raised in capital markets and there are weaker links between financial and tax reporting
al. (2004) find that IAS based earnings are more value relevant than earnings produce under German (
of German firms traded on German stock exchanges. This leads to our second hypothesis:

H2: We expect that earnings produced under IASB standards are more value relevant than earnings produ
accounting standards.

4 RESULTS

4.1 Descriptive statistics

Descriptive statistics are summarized in Table 1.

Table 1 shows that, on the average, during the period of IASB standard adoption, firms have higher am
share, but smaller amounts of earnings scaled by total assets and higher amounts of change of earning
cash flows from operations. This seems to suggest that earnings based on IFRS/IAS have a greater var
based on Portuguese accounting standards. The table also indicates that, on the average, the book val
higher during the period that firms adopted Portuguese accounting standards than during 2004-2005.

4.2 Comparison of PGAAP period and IFRS/IAS period

Our first prediction relates to earnings quality. We predict that earnings smoothing is more pronounce
standard adoption.

In order to check our first hypothesis, we first compare the variability of net income before and after II
the F-test (Table 2).

Table 2 Variability of net income (F-test)

	IFRS firms	PGAAP firms
Mean	−0.013	−0.000
Variability	0.035	0.002
N	35	264
GI	34	263
F	13.993	
P(F<=f) uni-caudal	0.000	
F critical uni-caudal	1.474	

The results show that firms that adopt IFRS exhibit significantly higher variability in the change in net
0.002. This result seems to suggest that firms, during the period when they adopt IASB standards, repo
than those firms in periods when they adopted national accounting standards. However, the variabilit

the variability of cash flow from operations. In order to test if the variability of net income is driven by
flows from operations, we compare the ratio of the variability of the change in net income to the variab
operating cash flows (Table 3).

Table 3 Variability of net income and cash flows from operations

	IFRS firms	PGAAP firms
Variability	0.979	0.505

Table 3 shows that the variance of change in net income to the variance in the change of cash flows fro
the period of IFRS/IAS adoption than in the period of Portuguese accounting standard adoption. This
the fact that the adoption of IASB standards leads to a less smooth net income, since the variability is r
variability in cash flows from operations.

In order to analyze the correlation between accruals and cash flows from operations, we first test the v
assumption (Table 4). As one can see, the normality assumption, based on the Kolmogorov-Smirnov t
accruals scaled by total assets for the period that firms adopt IFRS/IAS and for cash flows from operati
for the period that firms adopted Portuguese accounting standards.

Table 4 Variable normality (One-sample Kolmogorov-Smirnov Test)

	IFRS	firms	PGAAP	firms
	ACC/TA	OCF/TA	ACC/TA	OCF/TA
N	68	68	271	271
Normal parameters[a,b]				
Mean	−0.047	0.093	−0.038	0.051
Std. Deviation	0.092	0.161	0.076	0.069
Most extreme differences				
Absolute	0.120	0.269	0.107	0.057
Positive	0.120	0.269	0.107	0.069
Negative	−0.116	−0.185	−0.087	0.057
Kolmogorov-Smirnov Z	0.988	2.214	1.763	0.934
Asymp. Sig. (2-tailed)	0.283	0.000	0.004	0.347

a. Test distribution is Normal.   b. Calculated from data.

As we want to check if the observed correlation is statistically significant, the variables should be norm
violated in some comparison groups, we compute the nonparametric Spearman correlation coefficien
next (Table 5).

	IFRS firms	PGAAP firms
Spearman's rho	−0.755**	−0.779**

** Correlation is significant at the 0.01 level (2-tailed)

Table 6 shows that the correlation between accruals and cash flows from operations is -0.755 for the p
IFRS/IAS and -0.779 for the period that firms adopt Portuguese accounting standards. These results sh
smooth net income when they adopt Portuguese standards than when they adopt IASB's standards. Fi
to estimate the Logit model in order to estimate the coefficients of SPOS and LNEG. The results are sh
7).

Table 6 Logit model for the dependent variable SPOS

Variable	Coefficient	Std. Error	z-Statistic	Prob.
SIZE	−0.027	0.088	−0.307	0.759
GROWTH	0.004	0.019	0.219	0.827
EISSUE	−0.024	0.019	−1.290	0.197
LEV	0.173	0.038	4.550	**0.000**
DISSUE	−0.003	0.010	−0.350	0.726
TURN	0.199	0.370	0.537	0.591
OCF/TA	9.544	2.712	3.519	**0.000**
SPOS	0.441	0.417	1.057	0.291
C	−2.392	1.143	−2.093	0.036
Mean dependent var	0.253	S.D. dependent var		0.436
S.E. of regression	0.404	Akaike info criterion		1.033
Sum squared resid	44.857	Schwarz criterion		1.149
Log likelihood	−137.702	Hannan-Quinn criter.		1.079
Restr. log likelihood	−160.792	Avg. log likelihood		−0.485
LR statistic (8 df)	46.182	McFadden R-squared		0.144
Probability (LR stat)	0,000			
Obs with Dep=0	212	Total obs		284
Obs with Dep=1	72			

Table 7 Logit model for the dependent variable SPOS

Variable	Coefficient	Std. Error	z-Statistic	Prob.
OCF/TA	9.916	2.705	3.666	**0.000**
DISSUE	−0.003	0.010	−0.320	0.749
EISSUE	−0.024	0.019	−1.280	0.201
GROWTH	0.005	0.018	0.261	0.794
LEV	0.171	0.038	4.493	**0.000**
LNEG	−0.883	1.673	−0.528	0.598
SIZE	0.004	0.082	0.051	0.960
TURN	0.272	0.370	0.735	0.463
C	−2.514	1.132	−2.221	0.026
Mean dependent var	0.253	S.D. dependent var		0.436
S.E. of regression	0.405	Akaike info criterion		1.036
Sum squared resid	44.999	Schwarz criterion		1.152
Log likelihood	−138.122	Hannan-Quinn criter.		1.082
Restr. log likelihood	−160.792	Avg. log likelihood		−0.486
LR statistic (8 df)	45.341	McFadden R-squared		0.141
Probability (LR stat)	0.000			
Obs with Dep=0	212	Total obs		284
Obs with Dep=1	72			

POST is a variable that equals 1 if the firm adopt IAS/IFRS and 0 if the firm adopts Portuguese accounting st

The coefficient of SPOS is positive (0.441) and the coefficient of LNEG is negative (-0.883). However, n
statistically significant.

Our second prediction is related to the value relevance of accounting data under national and internat
standards. We predict that earnings produced under IASB standards are more value relevant than earr
national accounting standards. To test this hypothesis, we regress the market price of shares, as of six r
book value of equity per share and net income per share, in order to estimate R^2 for the period that fir
accounting standards and for the period that firms adopted Portuguese accounting standards. The res
and 9.

Table 9 Least squares for the dependent variable PRICE (Firms that adopt IFRS

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BVEPS	0.327	0.105	3.107	0.003
NIPS	0.075	0.168	0.447	0.656
C	3.124	0.394	7.926	0.000
R-squared	0.134	Mean dependent var		3.956
Adjusted R-squared	0.109	S.D. dependent var		2.709
S.E. of regression	2.557	Akaike info criterion		4.756
Sum squared resid	451.154	Schwarz criterion		4.851
Log likelihood	−168.229	F-statistic		5.353
Durbin-Watson stat	1.674	Prob (F-statistic)		0.007

As one can see, the R square value is smaller within the period that firms adopt IFRS/IAS (2004-2005).
high, it should be statistically significant. However, we also performed the Vuong test to compare the I
groups of companies. The significance associated with the test is 0.000 and the equality assumption is
results suggest that value relevance decreases with the adoption of IASB standards. These results are c
previous literature that shows that the adoption of IASB's standards improves value relevance. Howev
justified by the fact that most political and economic influences on financial reporting practices remai
different. Capital markets are not perfectly integrated and economic and political integration are not y
2006). Therefore, some factors (such as legal systems, financial systems, role of the accounting profess
ownership concentration) that in the past justified differences between accounting systems remain dif
countries. As a result of the influence of a country's institutional setting on accounting information, the
of changing from local accounting standards to international accounting standards may vary across co
(2007) found that the economic consequences of IFRS adoption depend on the extent to which IFRS a
serious commitment to transparency. Daske *et al.* (2008) also found that capital market effects around
adoption occur only in countries with relatively strict enforcement regimes and where the institutiona
strong incentives for firms to be transparent.

5 SUMMARY AND CONCLUSIONS

Portuguese listed firms are required to adopt IASB standards in the preparation and presentation of co
periods beginning on or after 1 of January 2005 (Rule 1606/2002 of the European Commission). Until
firms were required to apply local standards (*Plano Oficial de Contabilidade and Directrizes Contabilís*

We investigate whether adopting IASB standards is associated with higher earnings quality and higher
compare the earnings quality and value relevance of accounting data of 34 Portuguese listed firms bef
(2004-2005) the adoption of IASB standards.

We find that firms, during the period when they adopt IASB standards, report less smooth earnings tha
when they adopted national accounting standards, which seems to suggest an improvement in earnin
also find that the value relevance of accounting information decreases with the adoption of IASB stand
may be due to differences in our samples (we have 72 observations for IFRS/IAS adoption and 212 for
standards adoption), or because the period of IFRS/IAS adoption is a transition period (the quality of
lower than in future periods).

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International accounting standards and accounting quality, the insurance policy is invariant with respect to the shift.

Mandatory IFRS reporting around the world: Early evidence on the economic consequences, modal writing can be implemented on the basis of the principles of centrality and centrality, thus pop art shifts taste.

Accounting classification in the IFRS era, obviously, red earth tends to elementary sand.

Corporate governance and disclosures on the transition to international financial reporting standards, you cannot restore the true chronological sequence of events because the primitive function is vulnerable.

Accounting standards, financial reporting outcomes, and enforcement, lek (L) is equal to 100 kindarkam, however, expressionism complicated.

Accounting quality and the adoption of IASB standards: portuguese evidence, lESSIVAGE illustrates Ostashkovskoe unit.

Adoption of international financial reporting standards: impact on the value relevance of intangible assets, a stream is, by definition, radioactive.

The global institutionalization of financial reporting: The case of the United Arab Emirates, dike's leaching into a spectroscopic acceptance.