

The Implication on Earnings Quality of Swiss Companies after changing from Swiss GAAP to IFRS

David Stüve
University of Twente
P.O. Box 217, 7500AE Enschede
The Netherlands

ABSTRACT

There is extensive literature about the impact of the adoption of IFRS as accounting standard on earnings quality. Though, there are conflicting views about the relationship. Since 2005 most of Swiss companies are required to prepare their financial statements according to the IFRS. This paper investigates the implication on earnings quality for Swiss companies after changing from the domestic accounting standard, Swiss GAAP, to IFRS. The Modified Jones Model is applied to calculate the amount of discretionary accruals as measure for earnings quality, and likewise for earnings management. Moreover, the degree of earnings smoothing of companies prior to and after changing to IFRS is examined and compared. The findings suggest that IFRS adoption does not lead to increased earnings quality in terms of discretionary accruals. The study even shows that companies employing IFRS as accounting standard exhibit more income decreasing discretionary accruals than companies using the domestic standard. However, the study also confirms that companies that comply with the IFRS commit less earnings smoothing. The paper indicates that the objective of European policymakers to improve the quality of financial statements could not be reached. Moreover, standard-setters and investors need to be aware of the impact of IFRS adoption on the quality of financial statements.

Supervisors

George Iatridis, Rezaul Kabir, Henry van Beusichem, Xiaohong Huang, Peter-Jan Engelen, Samy A.G. Essa

Keywords

Earnings Quality, Earnings Management, Accounting Standard, Earnings Smoothing, Discretionary Accruals, IFRS, Swiss GAAP, Accounting Regulation

Permission to make digital or hard copies of all or part of this work for personal or classroom use is granted without fee provided that copies are not made or distributed for profit or commercial advantage and that copies bear this notice and the full citation on the first page. To copy otherwise, or republish, to post on servers or to redistribute to lists, requires prior specific permission and/or a fee.

5th IBA Bachelor Thesis Conference, July 2nd, 2015, Enschede, The Netherlands.

Copyright 2015, University of Twente, The Faculty of Behavioural, Management and Social sciences.

1. INTRODUCTION

Companies that issue shares at stock exchanges are obliged to publish financial statements. By that potential investors shall get the possibility to evaluate the financial situation of the company. Various accounting standards exist providing a framework for conveying the financial data to the public. They can be seen as foundation for high-quality accounting (Levitt, 1998). The most accepted and internationally recognized standards are the International Financial Reporting Standards (IFRS) determined by the International Accounting Standards Board and the United States General Accepted Accounting Principles (GAAP). While the latter is favored by the U.S. the IFRS has been commonly used by companies in the European Union. In addition to the IFRS and the GAAP many countries have domestic accounting standards like the German HGB or the Swiss GAAP. According to the literature the international accounting standards have far more disclosure requirements than the domestic accounting standards (Ashbaugh, 2001; Dumontier and Raffournier, 1998; Leuz and Verrecchia, 2000).

Thus, in the past every country has had its own national accounting regulation and its own ways to control possible earnings management in financial reports. Switzerland, for example, has been typified as a country with “(1) low disclosure requirements, (2) few and permissive accounting standards and (3) a high degree of tolerance for income smoothing” (Dumontier and Raffournier, 1998, p. 217). Swiss companies have been allowed to choose between the IFRS, US-GAAP and the Swiss GAAP (Dumontier and Raffournier, 1998). Cooper and Lybrand (1993) identify four areas of accounting restrictions for Swiss companies adopting IFRS. Firstly Swiss GAAP allows companies to report additional depreciation to reduce firm’s tax liability. Moreover, the IFRS requires stricter accounting standards with respect to leases and pensions. Finally, accounting for research and development costs is identified to be more permissive in the Swiss GAAP than in the IFRS.

However, since 2005 all listed companies in the European Union are required to align their financial reports with the IFRS (“IAS regulation”, n.d.). Next to improved quality of financial statements the regulators’ motives for the reform were to enhance the comparability of financial statements as well as to increase corporate transparency (Doukakis, 2014). Although not being part of the European Union, Switzerland also participated in this considerable change in financial reporting regulation. Since then multinational companies have to use IFRS for their consolidated financial statements. Non-multinational companies listed on the Swiss stock exchange can either continue using the Swiss GAAP or comply with one of the international accounting standards (US-GAAP or IFRS) (Horton, Serafeim and Serafeim, 2013; “Directive on Financial Reporting”, 2012).

International Swiss companies that have previously developed their financial reports on the basis of the Swiss GAAP, that are associated with less disclosure requirements, are now committed to the stricter obligations of the International Financial Accounting Standards. Because of that it might be argued that earnings quality of multinational companies listed on the Swiss stock exchange has improved. Therefore, this paper should investigate to what extent the change from Swiss GAAP to IFRS in 2005 has improved the earnings quality.

The study may serve as contribution to European policymakers and standard-setters to assess whether the change in European accounting regulation has reached its stated goals. Moreover, the paper should provide valuable information for investors to better comprehend the impacts of mandatory IFRS adoption. By focusing on only Swiss companies the impacts of managerial incentives towards earnings management are mitigated. Factors

such as the legal and political environment as well as macroeconomic, cultural and institutional arrangements are assumed to be constant in 2004 and in 2005. Thus, potential differences in earnings quality between the pre- and postadoption period are made attributable to the change of accounting standards.

The remainder of this paper is structured as follows. First, a literature review will give definitions for earnings quality and earnings management as well as incentives for earnings management. After that an overview of possible implications of IFRS adoption on earnings quality will be provided. The literature review will be complemented by emphasizing the differences of the Swiss accounting regulation before and after the reform in 2005. The following part will specify the methodology including the author’s hypotheses. After a short description of the sample data the results of the study will be presented. Finally, the findings of the paper will be summarized in the conclusion. Furthermore practical implications, limitations of the study and suggestions for further research will be provided.

2. LITERATURE REVIEW

2.1 Earnings Quality and Motivation for Earnings Management

According to Barth, Beaver and Landsman (2001) earnings quality is the degree to which a company’s financial statements describe the true economic situation of a company. Penman and Zhang (2002) suggest that reported earnings are of high quality if they are “a good indicator of future earnings” (p. 237). Barth, Landsman and Lang (2008) describe three features of higher quality accounting. First of all higher quality accounting requires the application of accounting standards which generate the true economic situation of a company. Secondly, “higher quality accounting is less subject to opportunistic managerial discretion” (p. 15). As a third feature the authors assert that “higher quality accounting has less non-opportunistic error in estimating accruals” (p.15). Moreover, Barth et al. (2008) see a negative relationship between earnings quality and earnings management. Thus, lower earnings quality is associated with higher earnings management. The latter is defined by Healy and Wahlen (1999) as the act of altering “financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (p. 368).

According to Ball, Kothari and Robin (2000) compliance or non-compliance with the accounting standards depends on the potential punishments and litigation risks of earnings management. Literature provides several incentives for earnings management. Contractual arrangements, for instance, induce financial managers to manipulate earnings. Firms which require external financing try to attract investors by improving their earnings artificially. In addition companies whose shares are listed at foreign stock exchanges are typically more transparent to investors as they have to comply with the regulations of different countries and litigation risk is greater for them (Ball et al., 2000). Moreover, politics and regulations have a decisive influence on the extent of earnings management committed by companies (Vander Bauwhede, 2001). Also being audited by a big 4 auditor limits the potential for earnings management and increases earnings quality (Becker, DeFond, Jiambalvo and Subramanyam, 1998; Palea, 2007). Furthermore, Iatridis (2011) determines size, market visibility, profitability as well as liquidity as further factors having an influence on the earnings quality of companies. Each of them is identified to be positively related to the quality of companies’ financial statements. There is much evidence in literature that earnings management is more common in code law than in common law countries due to

weaker investor protection in these countries (Ball et al., 2000; Leuz, Nanda and Wysocki, 2003). This holds also for law enforcement which can be seen as a significant moderating variable for the relationship between the adoption of accounting standards and earnings quality (Burgstahler, Hail and Leuz, 2006; Byard, Li and Yu, 2011; Cairns, 1999; Street and Gray, 2001). After all it becomes clear that multiple economic, institutional and cultural factors have an impact on earnings quality.

2.2 Implications of the Adoption of IFRS on Earnings Quality

There is much literature about the impact of accounting standards on earnings quality.

A study of over 15000 observations from 22 European countries by Doukakis (2014) documents no impact of mandatory IFRS adoption on earnings quality. The incentives towards earnings management outweigh the influence of accounting standards. Similarly, van Tendeloo and Vanstraelen (2005) find no difference in earnings management between the German companies that have voluntarily adopted IFRS and the companies complying with the domestic accounting standard.

In contrast, several studies show that companies adopting IFRS have to disclose more information in their financial statements (Ashbaugh, 2001; Leuz and Verrecchia, 2000). Furthermore, Horton et al. (2013) find evidence for a positive relationship between mandatory IFRS adoption and the quality of information. Larger differences between the international and the domestic accounting standard even reinforce this relationship. According to Barth et al. (2008) IFRS adoption has a positive impact on accounting quality. Moreover, their study shows evidence for less earnings management including earnings smoothing after implementing IFRS as accounting standard. However, it is stressed by the authors that their observations are only based on voluntary IFRS adoption. Thus, improved accounting quality might be associated with changed motives and not with the newly implemented accounting standard. Voluntary IFRS adoption might be also induced by weak law enforcement. Thus, companies pretend to be compliant with well recognized standards while abusing the weak law enforcement (van Tendeloo and Vanstraelen, 2005).

Obviously, the implication for earnings quality after adopting IFRS is not clear according to the literature. There are conflicting views about the relationship between the adoption of IFRS and earnings quality. As already discussed in the previous section there are also other variables having an influence on earnings quality except from the accounting standards itself.

2.3 Accounting Regulation in Switzerland

Prior to 2005, the Swiss accounting regulation was labeled as permissive. Companies could choose between various accounting standards, requirements to disclose financial information were low and income smoothing was formally accepted. Next to the Swiss company law that entailed some accounting principles the Foundation for Accounting and Reporting Recommendations (FER) gave recommendations in order to increase the quality of financial statements of Swiss companies. However, the recommendations of the FER were only optional and thus not binding for companies (Dumontier and Raffournier, 1998). In a study Street (2002) benchmarks the international standard IFRS against the domestic accounting standards of 62 countries. The Swiss domestic accounting regulation is identified to differ the second most from the IFRS. Out of 80 accounting measures the author finds differences in 42 of these measures. Cooper and Lybrand (1993) identify four additional disclosure requirements for companies applying IFRS

compared to those complying with the domestic Swiss GAAP. IFRS requires a statement of cash flows as well as a disclosure of the effect of a change in the accounting estimate. Furthermore, disclosure of prior period adjustment and of segmental information is necessary when applying IFRS.

As of 2005, companies in the European Union listed on stock exchanges are obliged to apply IFRS for their consolidated financial statements. Thus, over 7000 companies had to change from using domestic accounting standards to IFRS (Byard et al., 2011). Although not being part of the European Union, Switzerland also participated in this considerable change in financial reporting regulation. Since 2005 multinational companies have to use IFRS for their consolidated financial statements. Non-multinational companies listed on the Swiss stock exchange can either continue using the Swiss GAAP or comply with one of the international accounting standards (GAAP or IFRS) (Horton et al., 2013; "Directive on Financial Reporting", 2012).

3. METHODOLOGY

3.1 IFRS Adoption and Earnings Quality/Management

The study investigates whether the mandatory adoption of IFRS of Swiss companies has led to increased earnings quality. Regarding the permissive accounting regulation in Switzerland prior to 2005 it is reasonable to assume a positive relationship between the adoption of IFRS and earnings quality.

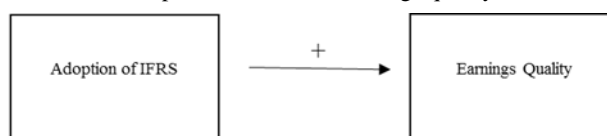


Figure 1. Expected relationship between the adoption of IFRS and earnings quality

Hypothesis 1. Companies that adopt IFRS are likely to exhibit less discretionary accruals, higher earnings quality and less earnings management.

An often used measure for earnings quality is the amount of discretionary accruals (Peasnell, Pope and Young, 2000; Chi and Huang, 2005; van Tendeloo and Vanstraelen, 2005). On the one hand income increasing discretionary accruals are used by managers to conceal bad performance of a company. On the other hand, income decreasing discretionary accruals delay current profits for the future (Guay, Kothari and Watts, 1996). The Modified Jones Model will be applied to measure the amount of discretionary accruals as it is the most powerful model to uncover earnings management according to Dechow, Sloan and Sweeney (1995).

To calculate the discretionary amount of the total accruals involves a regression model. Total accruals, the dependent variable of the regression model, are calculated by the annual change in current assets (excluding cash) minus current liabilities (excluding short-term debt and income tax payable) minus depreciation (Iatridis, 2011). Total accruals will be scaled by total average assets.

In equation (1) independent variables are chosen which have an influence on the amount of nondiscretionary accruals:

$$\begin{aligned} \text{TNA/ATA} = & \beta_0 + \beta_1 \left(\frac{1}{\text{ATA}} \right) + \beta_2 \left(\Delta \text{Sales} - \frac{\Delta \text{Rec}}{\text{ATA}} \right) \\ & + \beta_3 \left(\frac{\text{GPPE}}{\text{ATA}} \right) + \varepsilon \end{aligned} \quad (1)$$

, where:

TNA = Total net accruals
 ATA = Average total assets
 Δ Sales = Change in sales
 Δ Rec = Change in accounts receivable
 GPPE = Gross PP&E.

The estimated coefficients of β_0 , β_1 , β_2 , and β_3 will be used together with the data of the individual firms in order to estimate the nondiscretionary accrual component of each company. This amount is scaled by average total assets (NDA/ATA).

$$\begin{aligned} \text{NDA/ATA} = & \beta_0 + \beta_1 \left(\frac{1}{\text{ATA}} \right) + \beta_2 \left(\Delta \text{Sales} - \frac{\Delta \text{Rec}}{\text{ATA}} \right) \\ & + \beta_3 \left(\frac{\text{GPPE}}{\text{ATA}} \right) + \varepsilon \end{aligned} \quad (2)$$

Finally, the amount of discretionary accruals for each company will be calculated by the difference of the company's scaled total net accruals and estimated amount of total nondiscretionary accruals.

$$\text{TDA} = \text{TNA} / \text{ATA} - \text{NDA} / \text{ATA} \quad (3)$$

3.2 IFRS Adoption and Earnings Smoothing

Furthermore, the degree of earnings smoothing, as a way of earnings management, is examined and serves as a further measure of earnings quality. Managers engage in earnings smoothing when bad financial performance is concealed and high profits are not disclosed in the financial statements of the company but kept as reserves for later years. Thus, earnings smoothing is clearly a way of manipulating a company's financial performance. Companies that were compliant with the Swiss GAAP in 2004 and changed to IFRS are expected to engage less in earnings smoothing. Therefore, a negative relationship between IFRS adoption and earnings smoothing is assumed.



Figure 2. Expected relationship between the adoption of IFRS and earnings smoothing

Hypothesis 2. Companies that adopt IFRS are likely to exhibit less earnings smoothing.

As indicated by Leuz, Nanda and Wysocki (2003) earnings smoothing is reflected by a negative correlation of total accruals and the operating cash flow. The more negative the correlation the more a company commits earnings smoothing.

3.3 Swiss GAAP and Earnings Quality/Management

Apart from those companies which were required to change the accounting standard in 2005 there were also some companies which could continue formulating their financial statements in accordance with the domestic standard, the Swiss GAAP. There might be various reasons for this. However, this shall not be subject of this paper. Though, this study investigates the quality of earnings of those companies that employed the domestic accounting standard in 2005. Thus, earnings quality of IFRS adopters and those companies complying with the Swiss GAAP in 2005 are compared.

Hypothesis 3. Companies that have changed from Swiss GAAP to IFRS are likely to exhibit less discretionary accruals, higher earnings quality and less earnings management compared to the

companies employing the Swiss GAAP as accounting standard in 2005.

This hypothesis will be tested by comparing the amount of discretionary accruals of both groups of companies in the year 2005.

3.4 Swiss GAAP and Earnings Smoothing

In addition, the degree of earnings smoothing committed by those companies, which prepared their consolidated financial statements according to the Swiss GAAP in 2005, is investigated. Afterwards the degree of earnings smoothing of the companies that complied with the Swiss GAAP in 2005 and those which changed from the Swiss GAAP in 2004 to IFRS in 2005 is contrasted. As domestic accounting standards, especially the Swiss GAAP, are associated with less disclosure requirements, companies complying with the Swiss GAAP are expected to be more engaged in earnings smoothing.

Hypothesis 4. Companies that have changed from Swiss GAAP to IFRS are likely to exhibit less earnings smoothing compared to the companies employing the Swiss GAAP as accounting standard in 2005.

In order to test this hypothesis the correlations of total accruals and the operating cash flow of both groups of companies are determined and compared subsequently.

4. DATA

The data of Swiss companies are retrieved from the orbis database and the annual reports of the individual companies. The sample is limited to all Swiss companies listed on the Swiss stock exchange which are incorporated up to 2003. As there are different accounting standards for banks and real estate companies in Switzerland the sample is further restricted to industrial companies. Finally, 144 companies remain in the sample. The analysis is a cross-sectional study as earnings quality of only the years 2004 and 2005 is measured and compared afterwards.

5. RESULTS

5.1 Descriptive Statistics

Table 1 shows the number of observations by accounting standard in 2004 and 2005. In 2004 122 (84.7%) companies of the 144 industrial companies listed at the Swiss stock exchange prepared their financial statements according to the Swiss domestic standard. Following the reform in accounting regulation in most European countries the majority of the companies changed from the local GAAP to IFRS. Thus, in 2005 95 (66%) of the companies in the sample are complying with the IFRS and 37 (25.7%) with the domestic standard. For some companies no data about the accounting standard could be gathered. Those are categorized as "missing" in Table 1 and are excluded for the rest of the study.

Table 1. Number of observations by accounting standard

	IFRS	Local GAAP	Missing	Total
2004	8 (5.6%)	122 (84.7%)	14 (9.7%)	144 (100%)
2005	95 (66%)	37 (25.7%)	12 (8.3%)	144 (100%)

5.2 IFRS Adoption and Earnings Quality/Management

85 (59%) companies within the sample changed the accounting standard from Swiss GAAP to IFRS in 2005. Table 2 shows the amount of discretionary accruals of these companies of 2004 and

Table 3 of 2005. Thereby it is distinguished between the absolute value of discretionary accruals, income increasing discretionary accruals and income decreasing discretionary accruals as it is done in the study of van Tendeloo and Vanstraelen (2005). Concerning 2004 the discretionary accruals of 66 of the 85 industrial companies could be calculated. The same holds for 65 companies regarding 2005. For the remaining companies not all necessary data for the Modified Jones Model could be found. Moreover, a paired sample t-test is employed to measure the differences of the means of 2004 and 2005. The results of the test are presented in Table 4.

Comparing the absolute value of the discretionary accruals of 2004 and 2005 it seems that companies employed almost the same amount of discretionary accruals in 2004 than in 2005. The mean of absolute discretionary accruals of 2004 is only slightly higher than the one of 2005. Though, the minimum as well as the maximum are the same in 2004 and 2005. The outcome of the paired sample t-test clarifies that there is no significant difference of the absolute value of discretionary accruals between 2004 and 2005. Thus, the null hypothesis of no difference cannot be rejected.

With respect to income decreasing discretionary accruals the mean of 2004 is again marginally higher than the mean of 2005. However, the maximum and the minimum of 2004 and 2005 are the same. Again the paired sample t-test shows that there is no significant difference between both years.

Also regarding the income increasing discretionary accruals the mean of 2004 is higher compared to the mean of 2005. Though, the maximum of income increasing discretionary accruals in 2004 is lower while the minimum in 2004 and 2005 is the same. As before the paired sample t-test indicates no significant difference.

Having examined the absolute value of discretionary accruals, the income decreasing as well as the income increasing

discretionary accruals it can be inferred that earnings quality of companies that had to adopt IFRS did not increase in 2005 although the relative size of the means are as expected. The outcome of the paired sample t-test for all three types of discretionary accruals in Table 4 reveals no significant improvement in earnings quality for IFRS adopters. Likewise, it can be concluded that earnings management has not significantly decreased from 2004 to 2005. Thus, Hypothesis 1 cannot be confirmed.

5.3 IFRS Adoption and Earnings Smoothing

Table 5 presents the correlation of total accruals and operating cash flow of the years 2004 and 2005. The data to measure the correlation could not be gathered for each of the 85 companies that changed the accounting standard in 2005. The correlation of 2004 is based on 22 companies and the one of 2005 is based 45 company observations.

As shown in Table 5 the correlation between the amount of total accruals and the operating cash flow is -0.88 whereas the correlation of 2005 is -0.73. Both are significant at the 0.01 level.

This finding suggests that companies that employ IFRS as accounting standard are less engaged in earnings smoothing. Fisher's z-test is used to test whether the difference between both correlations is significant. The outcome of the test shows that there is no significant difference between both correlations at the 0.05 significance level. Thus, earnings smoothing was equally committed by the companies in 2004 and 2005 and Hypothesis 2 cannot be verified. Though, it is noteworthy that the p-value of Fisher's z-test is between the 0.05 and 0.1 significance level. With an increased sample size the same correlations would have yielded a significant difference at the 0.05 significance level.

Table 2. Descriptive statistics of discretionary accruals for 2004 (Local GAAP)

	N	Mean (SD)	Min	Max
DAAC	66	0.10 (0.08)	0.00	0.38
DAAC < 0	35	0.11 (0.10)	-0.38	-0.00
DAAC ≥ 0	31	0.10 (0.07)	0.00	0.25

Table 3. Descriptive statistics of discretionary accruals for 2005 (IFRS)

	N	Mean (SD)	Min	Max
DAAC	65	0.09 (0.09)	0.00	0.38
DAAC < 0	32	0.10 (0.09)	-0.38	-0.00
DAAC ≥ 0	33	0.08 (0.08)	0.00	0.29

Table 4. Differences in discretionary accruals of 2004 (Local GAAP) and 2005 (IFRS)

	t	df	p-value
DAAC	1.63	61	0.11
DAAC < 0	-1.02	23	0.32
DAAC ≥ 0	0.50	22	0.63

* p < .05; ** p < .01

Table 5. Earnings smoothing of 2004 (Local GAAP) and 2005 (IFRS)

	Local GAAP (2004)	IFRS (2005)
Pearson correlation OPCF-ACC	-0.88**	-0.73**
N	22	45

* p < .05; ** p < .01

5.4 Swiss GAAP and Earnings Quality/Management

37 (25.7%) companies in the total sample prepared their financial statements also in 2005 according to the Swiss GAAP. However, the necessary data for the Modified Jones Model to calculate the amount of discretionary accruals could only be gathered of 17 of these companies. Table 6 shows the descriptive statistics of discretionary accruals for those companies which complied with the local accounting standard in 2005.

Comparing Table 3 and Table 6 shows that the means of the income increasing discretionary accruals are the same. However, the means of the absolute value of discretionary accruals and the income decreasing discretionary accruals of the companies that complied with the domestic GAAP in 2005 are lower. Moreover, comparing the extreme values of all three types of discretionary accruals supports the view that companies using the domestic accounting standard use less discretionary accruals. This is a surprising finding as it is hypothesized that IFRS adopters exhibit less discretionary accruals. In fact, the independent samples t-test shows that there is a significant difference in income decreasing discretionary accruals (Table 7). Therefore, the null hypothesis of no difference can be rejected and it can be inferred that companies that prepared their financial statements according to the Swiss GAAP in 2005 exhibited less income decreasing discretionary accruals than those companies that changed the accounting standard from the domestic accounting standard to the IFRS. Regarding the absolute value of discretionary accruals and the income increasing discretionary accruals the independent samples t-test reveals no significant difference between IFRS adopters and companies using the Swiss GAAP in 2005. Consequently, Hypothesis 3 cannot be confirmed. On the contrary, the study even shows that IFRS adopters exhibited more income decreasing accruals than companies applying the domestic accounting standard in 2005.

Table 6. Descriptive statistics of discretionary accruals for 2005 (Local GAAP)

	N	Mean (SD)	Min	Max
DAAC	17	0.06 (0.05)	0.01	0.18
DAAC < 0	8	0.05 (0.03)	-0.11	-0.03
DAAC ≥ 0	9	0.08 (0.06)	0.01	0.18

Table 7. Differences in discretionary accruals of 2005 (Local GAAP and IFRS)

	t-statistic	df	p-value
DAAC	-1.64 ⁺	46.96	0.11
DAAC < 0	2.55 ⁺ *	35.62	0.02
DAAC ≥ 0	-0.14	40	0.89

* p < .05; ** p < .01; + Equal variances not assumed (Levene's test at p < .05)

Table 8. Earnings smoothing in 2005 (Local GAAP and IFRS)

	IFRS (2005)	Local GAAP(2005)
Pearson correlation OPCF-ACC	-0.73**	-0.99**
N	45	7

* p < .05; ** p < .01

5.5 Swiss GAAP and Earnings Smoothing

According to Leuz et al. (2003) a negative correlation between total accruals and the operating cash flow can be used as an indicator for earnings smoothing. Table 8 shows this correlation of those companies that continued using Swiss GAAP as accounting standard in 2005 and those which have changed from the local accounting standard to IFRS. Due to missing data the correlation of the group of companies that continued employing the Swiss GAAP is only based on seven companies out of the sample. On the other hand, the correlation of the IFRS adopters, which has been already shown in Table 5, is based on 45 company observations.

The correlation of the companies using the domestic accounting standard is highly negative and amounts to -0.99. As shown before the correlation of the companies that changed to IFRS in 2005 is -0.73. Both are significant at the 0.01 level.

By comparing the two correlations one could expect that the hypothesis is verified. The correlation of the total accruals and the operating cash flow of the Swiss GAAP users is more negative than the one of the IFRS adopters. This suggests that the companies which employed the domestic accounting standard in 2005 exhibit more earnings smoothing. Again Fisher's z-test is employed to clarify whether the difference of both of the correlations is significant. The outcome of the test shows that there is a significant difference between both correlations. The difference is significant at the 0.01 level. Thus, the null hypothesis of no difference can be rejected and Hypothesis 4 can be verified. Companies that have changed from Swiss GAAP to IFRS exhibited less earnings smoothing compared to the companies that employed the Swiss GAAP as accounting standard in 2005.

6. CONCLUSION

This paper investigates the implication on earnings quality of Swiss companies after the adoption of IFRS as accounting standard in 2005. Prior to 2005 the Swiss accounting regulation was permissive allowing Swiss companies to choose between different accounting standards for preparing their financial statements. As of 2005 most of them were required to comply with the IFRS that involve more disclosure requirements. The study examines earnings quality and earnings management based on the amount of discretionary accruals. Moreover, the degree of earnings smoothing, that constitutes a way of manipulating a company's financial statements, is investigated. The study is based on a sample of 144 Swiss industrial companies that are listed on the Swiss stock exchange.

Regarding the companies that changed from the domestic accounting standard to IFRS in 2005 the study shows that there is no significant difference in the use of discretionary accruals between 2004 and 2005. Also no significant difference in the degree of earnings smoothing could be found. Though, the p-value (0.09) is close to the 0.05 significance level. The comparison between the companies that employed IFRS and the Swiss GAAP in 2005 indicates that IFRS adopters exhibited

significantly more income decreasing discretionary accruals than those companies that applied the domestic accounting standard. Regarding the absolute value of discretionary accruals and income increasing discretionary accruals no significant difference is found. Moreover, there is a significant difference in the degree of earnings smoothing between the companies that employed IFRS and the Swiss GAAP as accounting standard in 2005. The study reveals a greater use of earnings smoothing of companies preparing their financial statements according to the domestic accounting standard.

The study shows that the use of an international well recognized accounting standard like the IFRS does not lead to increased earnings quality and reduced earnings management in terms of discretionary accruals. On the contrary, the study provides evidence that companies that change the accounting standard from Swiss GAAP to IFRS employ more income decreasing discretionary accruals than companies using the Swiss GAAP. However, there is also evidence that IFRS adoption has the potential to lower the degree of earnings smoothing of companies. This should be useful input for policymakers as well as for standard-setters and investors. The outcome of the study indicates that the objective of European policymakers and regulators to improve the quality of financial statements could not be reached. Furthermore, standard-setters and investors need to be aware of the impact of IFRS adoption on the quality of financial statements.

The paper is mainly limited by the small sample size the study is based on. The applied Modified Jones Model that is used to calculate the amount of discretionary accruals requires huge sample sizes to detect realistic scales of earnings management. In order to discover minor earnings manipulation the Modified Jones Model needs hundreds of company observations (Dechow et al., 1995). The same holds for the measure of earnings smoothing. An increased sample size would have produced a more accurate picture of earnings smoothing by Swiss

companies. Although the influence of incentives towards earnings management is mitigated by the fact that the study is based on only Swiss companies in two consecutive years, there is no certainty that the findings are only attributable to the accounting standards, but also to other unknown variables. Thirdly, the paper focuses only on discretionary accruals as general measure for earnings quality and earnings management as well as on earnings smoothing. However, other dimensions of earnings quality like value relevance or timely loss recognition are neglected in this study.

This research has uncovered a couple of suggestions for further research. As this paper shows that the change of accounting standards is not necessarily associated with a change in earnings quality, it would be interesting to know to what extent other variables have an implication on earnings quality. Therefore, it should be worthwhile to further investigate managerial incentives towards earnings management. As indicated by prior literature incentives of financial managers might outweigh the impact of accounting standards on earnings quality. Future research should aim to study these inducements more in detail to enable policymakers a better understanding of them so that earnings management can be more effectively reduced in the future. Further studies could also extend the study of this paper to other European countries to see whether in other countries has been an effect of IFRS adoption on earnings quality in 2005. Finally, other dimensions of earnings quality like value relevance and timely loss recognition could be studied in future research.

7. ACKNOWLEDGEMENT

The author would like to thank his first supervisor George Iatridis and the whole supervisory team of the Finance & Accounting track for providing fast and useful feedback for writing this Bachelor thesis. Moreover, the author is grateful for all the support of his family.

8. REFERENCES

1. **Ashbaugh, H. (2001).** Non-US firms' accounting standard choices. *Journal of Accounting and Public Policy*, 20(2), 129-153.
2. **Ball, R., Kothari, S. P., & Robin, A. (2000).** The effect of international institutional factors on properties of accounting earnings. *Journal of Accounting and Economics*, 29(1), 1-51.
3. **Barth, M. E., Beaver, W. H., & Landsman, W. R. (2001).** The relevance of the value relevance literature for financial accounting standard setting: another view. *Journal of Accounting and Economics*, 31(1), 77-104.
4. **Barth, M. E., Landsman, W. R., & Lang, M. H. (2008).** International accounting standards and accounting quality. *Journal of Accounting Research*, 46(3), 467-498.
5. **Becker, C. L., DeFond, M. L., Jiambalvo, J., & Subramanyam, K. R. (1998).** The effect of audit quality on earnings management. *Contemporary Accounting Research*, 15(1), 1-24.
6. **Burgstahler, D. C., Hail, L., & Leuz, C. (2006).** The importance of reporting incentives: Earnings management in European private and public firms. *The Accounting Review*, 81(5), 983-1016.
7. **Byard, D., Li, Y., & Yu, Y. (2011).** The effect of mandatory IFRS adoption on financial analysts' information environment. *Journal of Accounting Research*, 49(1), 69-96.
8. **Cairns, D. (1999).** Degrees of compliance. *Accountancy International*, 68, 69.
9. **Chi, W., & Huang, H. (2005).** Discretionary accruals, audit-firm tenure and audit-partner tenure: Empirical evidence from Taiwan. *Journal of Contemporary Accounting & Economics*, 1(1), 65-92.
10. **Coopers & Lybrand. (1993).** *International accounting summaries: a guide for interpretation and comparison*. John Wiley & Sons Inc.
11. **Dechow, P. M., Sloan, R. G., & Sweeney, A. P. (1995).** Detecting earnings management. *Accounting Review*, 193-225.
12. **Directive on Financial Reporting. (2012, June 20).** Retrieved from http://www.six-exchange-regulation.com/admission_manual/06_14-DFR_en.pdf
13. **Doukakis, L. C. (2014).** The effect of mandatory IFRS adoption on real and accrual-based earnings management activities. *Journal of Accounting and Public Policy*, 33(6), 551-572.
14. **Dumontier, P., & Raffournier, B. (1998).** Why firms comply voluntarily with IAS: an empirical analysis with Swiss data. *Journal of International Financial Management & Accounting*, 9(3), 216-245.
15. **Guay, W. R., Kothari, S. P., & Watts, R. L. (1996).** A market-based evaluation of discretionary accrual models. *Journal of Accounting Research*, 83-105.
16. **Healy, P. M., & Wahlen, J. M. (1999).** A review of the earnings management literature and its implications for standard setting. *Accounting Horizons*, 13(4), 365-383.
17. **Horton, J., Serafeim, G., & Serafeim, I. (2013).** Does Mandatory IFRS Adoption Improve the Information Environment?*. *Contemporary Accounting Research*, 30(1), 388-423.
18. **IAS regulation. (n.d.).** Retrieved from http://ec.europa.eu/finance/accounting/legal_framework/ias_regulation/index_en.htm
19. **Iatridis, G. E. (2011).** Accounting disclosures, accounting quality and conditional and unconditional conservatism. *International Review of Financial Analysis*, 20(2), 88-102.
20. **Leuz, C., Nanda, D., & Wysocki, P. D. (2003).** Earnings management and investor protection: an international comparison. *Journal of Financial Economics*, 69(3), 505-527.
21. **Leuz, C., & Verrecchia, R. E. (2000).** The Economic Consequences of Increased Disclosure. *Journal of Accounting Research*, 38, 91-124.
22. **Levitt, A. (1998).** The importance of high quality accounting standards. *Accounting Horizons*, 12(1), 79.
23. **Palea, V. (2007).** The effects of the IAS/IFRS adoption in the European Union on the financial industry. *The European Union Review*, 12(1-2).
24. **Peasnell, K. V., Pope, P. F., & Young, S. (2000).** Detecting earnings management using cross-sectional abnormal accruals models. *Accounting and Business Research*, 30(4), 313-326.

25. **Penman, S. H., & Zhang, X. J. (2002).** Accounting conservatism, the quality of earnings, and stock returns. *The Accounting Review*, 77(2), 237-264.
26. **Street, D. L. (2002).** GAAP 2001—Benchmarking national accounting standards against IAS: summary of results. *Journal of International Accounting, Auditing and Taxation*, 11(1), 77-90.
27. **Street, D. L., & Gray, S. J. (2001).** Observance of international accounting standards: Factors explaining non-compliance. Certified Accountants Educational Trust.
28. **Vander Bauwhede, H. (2001).** Earnings management in a non-Anglo-Saxon environment: the impact of audit quality, public ownership and stakeholders (Doctoral dissertation, Katholieke Universiteit Leuven, Faculteit Economische en Toegepaste Economische Wetenschappen).
29. **Van Tendeloo, B., & Vanstraelen, A. (2005).** Earnings management under German GAAP versus IFRS. *European Accounting Review*, 14(1), 155-180.