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The Impact of IFRS Adoption by Greek Listed Companies on the Earnings Quality: An Empirical Investigation

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Abstract:

Purpose: *The accuracy and reliability of financial statements is vital for business stakeholders in order to make the appropriate decisions. This has become increasingly important in recent years and its importance has intensified with the latest financial crisis, due to the bankruptcy of major financial institutions. The research conducted aims to study the relationship between profit management and long-term lending between two periods. More specifically, it will be considered whether businesses through long-term lending manipulate their earnings before and after the adoption of international Financial Reporting Standards (IFRS).*
Design/Methodology/Approach: *The sample consists of listed companies in the Athens Stock Exchange. One of the most authoritative methods that results in the most correct conclusions according to the bibliography is the modified model of "Jones".*
Findings: *The findings resulting from the survey suggest that for the years 2001-2004 there is no manipulation of profits through long-term lending as for the years 2005-2015.*
Practical Implications: *The primary goal of accounting standards adoption is to provide information for investors to make a wide range of decisions and contractual arrangements without their norms affecting the information quality on the reported earnings.*
Originality/Value: *The information provided through the reported financial statements based on IFRS is relevant and does not affect the quality of earnings.*

Keywords: *Financial reporting, earnings quality, accruals, non-discretionary accruals.*

JEL codes: *G30, G32, G35, G38, M41.*

Article type: *Research study.*

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1. Introduction

Fourteen years have been passed since the compulsory adoption of International Financial Reporting Standards (IFRS) by European Union (EU). The adoption of these standards has been a major change in the financial reporting and has been a subject of discussion in recent years. One of the main issues raised during the adoption of IFRS is the manipulation of profits. Manipulation of profits is a general term attributed to the accounting decisions affecting the results of financial reporting. Since 2005, all listed companies in the European Union (EU) are obliged to disclose their consolidated financial statements in accordance with the IFRS, which was ratified by the European Parliament. Before 2005, companies in the EU had the option to follow either the national "Generally Accepted Accounting Principles" (GAAP) or the IFRS (Arrunada, 2010).

The adoption of IFRS by EU countries aims to achieve comparability and transparency of financial reporting. In addition to comparability and transparency, IFRS also have a higher reference quality in financial statements. As a result IFRS adoption decreases the information asymmetry and agency costs, which share and stake holders were facing before the adoption of IFRS. Although the use of IFRS is mandatory for the listed companies only, there is a considerable number of non-listed firms that have chosen on a voluntary basis to adopt IFRS in order to strengthen their reputation and financial position. Ormrod and Taylor (2004) report that although IFRS aim to provide better financial reporting, some studies argue that the IFRS may facilitate the manipulation of profits.

In this context, our research focuses on the adoption and implementation of IFRS by listed companies in Greece under the concept of earnings' manipulation. In the case of Greece, in 2005, together with all EU countries, obligatorily adopted the IFRS for all listed firms, which resulted to an additional adaptation of IFRS by a number of non-listed firms as well. More specifically, this research examines the hypothesis that Greek listed firms manipulate their profits through the use of long-term loan financing and whether or not the adaptation of IFRS has an impact on this hypothesis.

2. Literature Review

The adoption of IFRS has become an international issue as the majority of developed countries have adopted their guidelines and norms (Liapis and Thalassinos, 2013; Thalassinos and Liapis, 2014). Consequently, investors and analysists are able to read, compare and evaluate the published financial information across countries more effectively. It is true that IFRS provide firms with such guidelines that firms are able to report their results based on their day to day operation and needs. Even though this flexibility is crucial for the firms, however it has its drawbacks as it gives them the opportunity to have a more elastic reporting policy that affects the published financial statements at various levels. One of these

drawbacks, which is also the subject of our research, is that firms have the flexibility to report their accounts in such a way that the hypothesis of manipulating their profits might be valid in many cases. On that basis, a significant number of articles have been dealt with the impact of the adoption of IFRS on their reported earnings and the possibility of manipulating them. On one hand, there are reports that support an improvement on results reported after the adoption of IFRS. More specifically, Cai (2008) reports evidence related to the reduction of the manipulation of profits after the adoption of IFRS. Similar findings are also reported by Aussenegg *et al.* (2008) in their research note that there is a reduction on profit manipulation after the adoption of IFRS in 17 European countries.

Furthermore, they associate the level of this reduction with the legal and fiscal characteristics of each country. In addition, Barth *et al.* (2008) have found a reduced extent of the manipulation of profits while improving the information asymmetries on the reported fair values and the time of identifying their losses. These results are in line with the findings of Christensen *et al.* (2015) that the manipulation of profits decreased and the early recognition of losses increased after the adoption of IFRS for some companies in Germany. Capkun *et al.* (2012) divided their sample into three groups: the early adopters, the late adopters and the mandatory adopters of IFRS in a sample consisted of 29 countries. Their results report that companies that adopted IFRS before 2005 are less involved in profit manipulation practices, while late adopters (companies that adopted IFRS in 2005) and mandatory adopters (companies that have the mandate to apply IFRS after 2005) are involved to a greater extent in profit manipulation practices.

On the other hand, several studies suggest that IFRS have a negative impact on the quality of financial reporting. Callao and Jarne (2010), in an investigation on the manipulation of earnings for eleven EU countries have found that the manipulation of profits has been intensified since the adoption of IFRS, as the non-discretionary accruals have increased in the period after the implementation of IFRS. Similar to Callao and Jarne (2010) findings are reported by Jeanjean and Stolowy (2008) which explored the impact of the adoption of IFRS by Australia, France and the United Kingdom firms. In their empirical results on Italian firms, Paglietti (2009) and Cameran *et al.* (2011), report that the quality level of the information provided by the published financial statements has been decreased after the adoption of IFRS mainly because of the manipulation of profits and the early recognition of losses.

Tendeloo and Vanstraelen (2005) examined a sample of German firms and, unlike Christensen *et al.* (2015), have found that the implementation of IFRS, at least in its initial stage of adoption, cannot be linked with an improvement on the manipulation of profits. Interesting are the results reported by Guenther *et al.* (2009) who argued that the manipulation of profits is reduced for the firms that voluntarily adopt the IFRS whereas the firms that had to adapt IFRS resulted to a higher level of profits manipulation. Katz (2009) finds that after the voluntary adoption of IFRS by private equity companies their reported quality of their profits has been increased. The

divergent findings mentioned above show that the effect of IFRS adoption on profit quality remains an open issue for businesses.

Barth *et al.* (2008) provide possible explanations for these contradictory results. One of the main reasons is the fact that the empirical investigation of these studies has been performed on different countries, where each country has its own legal, fiscal and economic environment build based on the particular country needs. Besides that, different studies use different measurements that cover different periods of time. An additional fact about these differentiations reported by Ahmed *et al.* (2013) and Moritz and Zoltan (2018) according to which one main reason for these contradictory results lies in the fact that researchers investigate the implementation of IFRS following assumptions based on different incentives that businesses might have for adopting them and therefore the outcome of their empirical investigation has been affected accordingly.

3. The Manipulation of Profits through Modeling of Accruals

In 1995 Dechow *et al.* reviewed the models of profit manipulation that existed up to then, focusing on the models proposed by Healy (1985), DeAngelo (1988) and Jones (1991) accordingly. Based on these, they set up their model, which is mainly known as the Jones Modified model. Healy's (1985) model which uses the accruals as a control variable for testing the manipulation of profits, whereas the Jones (1991) model is one of the most commonly used models in measuring the manipulation of earnings based on non-discretionary accruals. It does not consider that non-discretionary accruals are constant over time, as the previous models consider. Dechow *et al.* (1995) present a modified version of Jones' model, which was created in order to eliminate the incorrect measurement of non-discretionary accruals by Jones.

In addition, the Dechow *et al.* (1995) has been adjusted to revenues' variation based on changes in accounts receivables. In addition, it assumes that all changes in sales on credit, during the time where each sale took place, are directly linked with profits' manipulation, as it is easier to manipulate revenues when the payment takes place through cash. Based on the models' of Jones (1991) and Dechow *et al.* (1995), Kothari *et al.* (2005) controlled the effect on the non-discretionary accruals by introducing as new variable, the returns on asset (ROA). Additionally, Dechow and Sloan (1991) in their research assumed, similarly to Jones' model, that the non-discretionary accruals are not consistent over time. The difference is that their model considers that the variation of the determinants of non-discretionary accruals remains the same for all companies across same industries.

Our empirical research focuses on Greek listed firms, a country where a number of researches has been implemented so far. Greece was often at the forefront of research, due to the inadequate quality of financial reporting. Prior to the application of IFRS to all consolidated and individual accounts of companies listed on the stock

exchange from 1st January 2005, the quality of the Greek accounting standards and disclosure practices were the subject of criticism by the European financial press and investor's community (Doukakis, 2014). According to international empirical studies conducted prior the implementation of IFRS in Greece (Bhattacharya *et al.,* 2003; Leuz *et al.*, 2003) Greece presents the highest level of profit manipulation and opacity. More specifically, the main criticisms was that the Greek accounting standards allowed companies to use excessive discretion by not providing detailed information on disclosure as it was designed to meet users' information needs; thus it allowed reports to be heavily influenced by tax avoidance strategies since there was lack of an effective monitoring mechanism.

According to Cohen *et al.* (2004) the practices of profit manipulation are a pattern in the financial reporting process. The role of external auditors as a monitoring mechanism to ensure the integrity of accounting data were of high importance. However, the effectiveness of external audit in Greece has also been challenged by various parties, namely financial institutions, investors, journalists and politicians (Leventis *et al.,* 2011).

In their research, Iatridis και Rouvolis (2010) investigated the impact of the transition from Greek accounting standards to IFRS. Their findings present that the implementation of IFRS created disturbances on the reports and accounting figures for the Greek companies. Although the impact of IFRS in the first year of adoption seems to be unfavorable, probably due to the transition cost towards to IFRS, the financial figures reported by the Greek firms improved significantly within the next period. Moreover, Iatridis και Rouvolis (2010) show that the adoption of IFRS has resulted in the publication of accounting information that is more relevant to the fair value of the account reported.

Tsalavoutas and Evans (2010) examined the effect of IFRS on the book value of shareholders equity and net revenues during the transition period in Greece; contrary to the expectations, there is no significant change in the explanatory power of the regressions tested between the two periods of their sample. The shareholders' equity and Net Income indicators were positive and significant for both periods, prior and after the adoption of IFRS; furthermore it worth mentioning that the coefficient of shareholders' equity is significantly higher after the adoption of IFRS

In their research, Dimitropoulos *et al.* (2013) examined the impact of the adoption of IFRS on the quality of accounting information within the Greek accounting framework. Their findings claim that the quality of control improved and there is a beneficial effect on the quality of the published financial statements after 2005. Karampinis and Hevas (2013) investigated whether the adoption of IFRS in Greece influenced the tax incentives of manipulation of financial profits. Their findings support that taxation have a negative impact on the non-discretionary accruals which has been decreased after the adoption of IFRS. Karampinis and Hevas (2011) state that Greece is an example of unfavorable jurisdiction for the application of IFRS due

to its adherence in the law, the banking system, the protection of the rights of shareholders and the poor regulatory quality. Tsipouridou and Spathis (2012) report that the mandatory adoption of IFRS on the 1st of January 2005 aimed at improving the quality of financial reporting in Greece, which had been criticized for both manipulation practices on profits and inefficiency of external control.

4. Methodology and Results

According to literature review, there is a series of researches testing for profits manipulation. Our research focuses on the impact of IFRS adoption and implementation by the Greek listed companies questioning whether or not the manipulation of profits improved after 2005 in Greece we use the modified model of Jones, where the total accruals are divided into discretionary and non-discretionary accruals. More specifically the model used in our empirical investigation has the following form:

$$\frac{OTA_t}{TA_{t-1}} = b_1 \frac{1}{TA_{t-1}} + b_2 \left(DSales_t - DREC_t\right)/_{TA_{t-1}} + b_3 \, PPE_t/_{TA_{t-1}} + e_t$$

where, OTAt: are the net operational accruals, measured as the difference in cash flow operations from net earnings of the firm; TAt-1: are the total assets of the firm divided by the total assets in the beginning of the financial year; DSALES: is the first difference in net sales; DREC: is the first difference of receivables; PPE: are all the_tangible fixed assets; εt: is the error term which is a proxy for the non-discretionary accruals.

In order to conduct our research for the Greek listed companies in Athens Stock Exchange we set a set of restrictions. The first one considers the minimum number of firms that we should include in our sample in order to have a valid estimation. The second is related to the data collection period to have sufficient number of observations prior the mandatory adaption of IFRS by the Greek listed firms. The third restriction is that all firms should remain listed during the whole sample period. Following these restrictions resulted in a total of 38 companies that were listed from 2001 until 2015 with 5.130 observations in total. Our data divided into two sub-periods; 2001–2014, i.e., five years before the adoption of IFRS, and 2005–2015, ten years after the introduction of IFRS. Table 1 presents the summary statistics of our sample.

Table 1. *Descriptive data for our sample (in thousands)*

Period	2001-2004					2005-2015				
Variable	Average	Median	Min.	Max.	Stand. Error	Average	Median	Min.	Max.	Stand. Error
Lending	17	2,957	0	215,680	389,230	54,725	8,312	0	1,760,500	180,120
Long-term obligations	1,7116	2,957	0	181,160	36,908	62,172	11,478	204	1,849,600	188,320

Liabilities	162,510	56,570	1,596	2,729,300	399,610	289,960	64,284	93,320	7,054,800	873,080
Tangible assets	47,152	14,301	2,242	668,370	108,250	104,410	26,340	729	2,878,900	341,920
Receivables	37,203	14,931	2,065	547,850	77,347	46,378	11,798	615	1,001,800	135,710
Net income	12,804	1,375	-5,390	244,960	37,182	5,656	215	-313,500	322,570	41,354
Total assets	166,910	56,570	11,415	2,729,300	399,400	289,930	64,136	290	7054.800	873,140
Turnover-Sales	185,970	27,072	4,721	4,529,800	613,490	420,860	32,947	798	9,900,500	15,550,100
Cash flow from operational activities	19,212	2,594	-12,237	414,400	55,509	16,895	1,254	-204,030	677,830	77,113

For the sample of Greek companies an estimation of the above regression is made for the sub-intervals 2001-2004 and 2005-2015 (Table 2) The residuals of the regression are the measure of non-discretionary accruals and capture the manipulation of profits.

Table 2. *Results of modified Jones model (2001-2004 and 2005-2015)*

$$\frac{OTA_t}{TA_{t-1}} = b_1 \frac{1}{TA_{t-1}} + b_2 \left(DSales_t - DREC_t\right)/_{TA_{t-1}} + b_3 \, PPE_t/_{TA_{t-1}} + e_t$$

	2001 - 2004			2005 – 2015		
Coefficient	b_1	b_2	b_3	b_1	b_2	b_3
	487549	-0.0244422	-0.0635969	-2022650	-0.0244422	-0.0635969
Stand. Error	252517	0.0270390	0.0185375	181252	0.0270390	0.0185375
t-stat.	1.931	0.9040	-3.431	-11.16	-0.9040	-3.431
P-value	0.0554	0.3675	0.0008	<0,0001	0.3675	0.0008
R^2	0,022462			0.994077		
$R^2_{adj.}$	0,022442			0.994076		
F-stat.	1,141255			23217.13		
P-value	0,334459			<0,0001		
Schwarz criterion	430,3688			1202.710		
Akaike criterion	421,2972			1190.603		
Hannan-Quinn	424,9824			1195.389		

The results of the regression indicate that b3 coefficient is statistically significant. Because of the low R^2, (period 2001-2004) the model is not interpreted adequately. The P-value (0,334459) of the model is much greater than 5%, so the independent variables do not adequately interpret the dependent variable, so there is no good adjustment of the model over the period 2001-2004.

For the period 2005-2014 the regression equation is statistically significant. The results of the regression indicate that all three coefficients b1, b2, b3 are statistically significant and are sufficient to interpret the dependent variable.

Based on the above models we estimated the non-discretionary accruals for both

periods, i.e., before and after the adoption of the IFRS. Next we examine the correlation between them and the long-term lending under the hypothesis that companies distort their financial statements in order to apply for long term loans based on their manipulated results. In order to model this assumption we create a pseudo variable, Debt, which takes the value of 1 if the firm has increased its long term lending and 0 if it has not. More specifically the following criteria were applied:

- A value of 1 refers to businesses where long-term liabilities are greater than 40% of their total liabilities and have increased at least 30% in long-term borrowing between two consecutive years;
- A value of 0 is for businesses that do not apply the above criterio.

The equation used is as follows:

$$DA_t = a_1 + b_1 Debt_{i,t} + \varepsilon_t$$

where, DAt represents the residuals estimated during the previous stage.

The results of applying the model on our data for the years between 2001 and 2004 and 2005 and 2015 are presented in Table 3.

Table 3. *Regression results 2001-2004 and 2005-2015*

	$DA_t = a_1 + b_1 Debt_{i,t} + \varepsilon_t$			
	2001 - 2004		2005 – 2015	
	a_1	b_1	a_1	b_1
	-0.0166069	-0.0158977	-0.0242436	0.0124058
Stand. Error	0.00340282	0.0429344	0.00390054	0.0343978
t-stat.	-4.880	-0.3703	-6.215	0.3607
P-value	<0,0001	0.7117	<0,0001	0.7186
R^2	0.000913		0.000344	
$R^2_{adj.}$	-0.005747		-0.002301	
F-stat.	0.137106		0.130073	
P-value	0.711697		0.718558	
Schwarz criterion	433.4571		1089.607	
Akaike criterion	427.4093		1081.726	
1084.853	429.8661			

Based on our sample and according to our findings, the explanatory power of the estimated model is infinitesimal as the R^2 is close to zero for both periods of estimation, i.e., 2001–2004 and 2005–2015. The F-statistics have a P–Value higher than 70% proving that the model has no explanatory power for our data. Furthermore, the coefficient of Debt is not statistically significant in both estimations, whereas the constant tern of the model is negative and statistically

significant for both periods of estimation. Thus, according to our findings there is no evidence supporting the hypothesis that the companies under study manipulate their earnings through long-term lending during the periods considered.

5. Conclusion

The research carried out aimed to study whether businesses manipulate their earning through long term debt and if the transition from the Greek GAAP to IFRS improved their reporting quality. Based on the related literature review we focus on the influential works of Healy (1985), DeAngelo (1988), Jones (1991) Dechow *et al.* (1995) and test our hypothesis for earnings manipulation through long term debt for both periods, prior and after the adoption of IFRS by the Greek listed firms. Our investigation period covers fifteen years from 2001 to 2015. Our total number of firms that constitute our sample is 38 and represents the full population of Greek firms that are listed in the Athens Stock Exchange during these fifteen years.

Initially we applied the modified Jones' model for the two periods separately to assess the variables and residuals. Then the sample was split up in companies that proceeded to increase long-term debt under the hypothesis that firms manipulate their results through debt. Altogether for the years 2001-2004, 34 companies proceeded to increase their debt, while for the years 2005-2015 all 38 companies did so. Two more criteria were added to those firms which proceeded to increase their debt. The first croterio is the total long-term liabilities should exceed 40% of the total liabilities and the second the total long-term liabilities of year T should be greater than those of year T-1 by at least 30%.

It is apparent that the total long-term liabilities exceeding 40% of the total liabilities for the years 2001-2004 were only 4 companies and for the years 2005-2015 19 companies. As regards the criterion of the total long-term liabilities of year T to be greater than those of year T-1 by at least 30%, it is apparent that all 38 firms meet this criterion for the years 2001-2004, while for the years 2005-2015 32 companies do so. Our findings support the hypothesis that there is no evidence revealing any manipulation of profits linked with the long-term debt during both periods, prior and after the adoption of IFRS by the Greek listed firms.

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