

The Effect of IFRS Adoption on Accounting Conservatism – New Zealand Perspective

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Attestation of Authorship

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.

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Abstract

The impact of adopting International Financial Reporting Standards (IFRS) on earnings quality is intensively researched in recent years. This study investigates whether IFRS adoption has a positive effect on earnings quality proxied by accounting conservatism in New Zealand. The results suggest the existence of conditional conservatism for both pre- and post-adoption of IFRS. Furthermore, accounting conservatism is increased after the adoption of IFRS in New Zealand. Finally, accounting conservatism is improved for mandatory adopters but not for voluntary adopters after IFRS adoption. Thus, the overall findings suggest that the adoption of IFRS in New Zealand has a positive impact on earnings quality which stays in sharp contrast to the results of prior New Zealand studies/research.

Chapter 1: Introduction

Over the last decade, the global adoption of International Financial Reporting Standards (hereafter IFRS) has been one of the most momentous events in financial reporting sector. In late 2002, the Accounting Standards Review Board (ASRB) required all the New Zealand entities to apply IFRS from periods commencing on or after 1 January 2007 except that certain small businesses are exempted. An option of early voluntary adoption starting on or after 1 January 2005 is supplied. Whether IFRS adoption in New Zealand has a positive effect on earnings information quality is an issue of research interest, and the findings are expected to provide New Zealand practitioners, regulators and academics with empirical evidence on the accounting quality effect of IFRS adoption in a timely manner.

The key purpose of IFRS is to provide 'true and fair value' of corporations' financial position and performance to stakeholders including a high quality of earnings information. The establishment of a set of worldwide accepted accounting standard enables financial information of companies in different countries comparable. The preface to IFRS issued by International Accounting Standards Board (hereafter ISAB) illustrates that the core objective of IFRS is to develop a single set of uniformed, high quality, understandable and enforceable accounting standards that help participants in the various capital markets of the world to make economic decisions...' (Bebbington & Song, 2004; p. 8). It is argued that implementing IFRS enhances earnings quality through reducing information asymmetry, decreasing earnings management, providing more value relevant financial information to investors/shareholders, and decreasing cost of capital (Barth, Landsman, & Lang, 2008; Leuz, 2003; Paananen & Lin, 2009).

Research conducted in continental Europe¹ and other countries provide supportive evidence that earnings quality has been improved after IFRS adoption. For example, the adoption of IFRS is reported to improve transparency and comparability of financial reporting (Ashbaugh & Pincus, 2001; García Lara, Torres, & Veira, 2008), reduce information asymmetry between insiders and outside minority shareholders (Barth et al., 2008; Leuz 2003; Leuz & Verrecchia 2000), increase value relevance of earnings, reduce earnings management (Barth et al., 2008, Bartov et al., 2005), and lower the cost of equity capital (Daske et al., 2008; Ernstberger & Vogler, 2008; Shi & Kim, 2007).

Accounting conservatism is an intrinsic property of accounting (Huijgen & Lubberink, 2005). It pervasively exists in accounting standards, for instance, the lower of cost or market value for inventory valuation, fixed asset impairment test, and expensing majority of the research and development expenditure. Those requirements urge a certain degree of prudence being applied to recognizing assets and economic gains by accountants. Because of accounting conservatism requires accountants' higher degree of confirmation for good news than bad news (Basu, 1997), it is applied by researchers as one of the important proxies to evaluate the quality of earnings information (Watts, 2003). Previous research provides significant evidence that accounting conservatism affects the quality of financial information and protects investors from overstated firms' financial performance (LaFond & Watts, 2008; Lyengar & Zampelli, 2010; Watts, 2003). Therefore, it is argued that if adopting IFRS improves the overall quality of accounting information and reduces information asymmetry, the magnitude of accounting conservatism should be increased after the IFRS adoption (García Lara & Mora, 2004).

¹ In June 2002, EU's Council of Ministers issued a regulation requiring almost 7,000 European listed companies to apply IFRS starting 2005, and proposed to address accounting changes to the estimated 5 million European companies that are not subject to the IFRS Accounting Regulation (IAS Plus, 2003). Thereafter, most of the continental European countries started the adopting process. For the past 10 years, there are numerous researches have been conducted to evaluate the benefit and hidden problems of adopting IFRS based on the financial data acquired from those continental countries. Other countries, such as New Zealand, applied IFRS for periods commencing on or after 1 January 2007 and reporting entities have the option to adopt IFRS early from 1 January 2005. Hence, most of the existing researches on the effect of IFRS adoption are conducted in continental European countries.

Most of studies on IFRS effect are conducted by using European samples (Callao, Jarne, & Laínez, 2007; Ernstberger & Vogler, 2008; Gjerde, Knivsflå, & Sættem, 2008; E.K. Jermakowicz, 2004; Paananen & Lin, 2009; Van der Meulen, Gaeremynck, & Willekens, 2007; van Tendeloo & Vanstraelen, 2005) and samples of foreign private listed companies in the United States² (Gray, Linthicum, & Street, 2009; McAnally, McGuire, & Weaver, 2010). Those finding may not be able to be generalized to other countries as accounting quality is influenced by not only accounting standards but also other social factors such as legal and political environment and financial reporting incentives (Ball, Kothari, & Robin, 2000; Pope & Walker, 1999). Although New Zealand is one of the Anglo-Saxon countries which have a strong shareholder-oriented financial system, its distinct institutional features differentiate it from other Anglo-Saxon countries. Hence, the effect of IFRS adoption on conservatism in New Zealand may be different from extant studies conducted in EU countries and US markets. Furthermore, a few recent New Zealand studies are mainly conducted using sample of only voluntary adopters or without taking into account of the effect of voluntary adopters (Bridges, 2009; Rainsbury, San Diego, & Lyndon, 2008; Stent, Bradbury, & Hooks, 2010). However, Horton et al. (2008) and Krivogorsky et al. (2010) suggest that voluntary adopters have great incentives in adopting IFRS. Therefore, the impact of New Zealand voluntary adopters needs to be considered in research design. Kabir, Laswad, and Islam (2010) investigate both New Zealand voluntary and mandatory adopters through the proxy of discretionary accruals. My study differentiates Kabir et al. (2010) from different angle, the proxy of accounting conservatism is utilised to examine the earnings quality by applying Basu (1997)'s model.

Using 771 firm-year observations of New Zealand listed companies over the period 2000 - 2009, I find the existence of conditional conservatism for both pre- and post-adoption of IFRS. Furthermore, accounting conservatism is increased after the adoption of IFRS in New Zealand. Finally, accounting conservatism is improved for mandatory adopters but not for voluntary adopters. The impact of voluntary adopters mitigates the overall effect of IFRS on

² The U.S. Securities and Exchange Commission permitted foreign private issuers to file financial statements prepared in accordance with IFRS in 2007. However, US registered companies are still required to reconcile their accounts under US-GAAP.

conservatism in New Zealand. To the extent that accounting conservatism is economically relevant to reducing information asymmetry and contracting cost, and is thus connected to accounting information quality, my findings suggest that the adoption of IFRS in New Zealand has a positive impact on earnings quality.

This study makes contribution in three ways. First of all, I extend empirical literature on the accounting effect of IFRS adoption by investigating and providing new evidence from New Zealand. Second, the IFRS effect of voluntary adopters has been taken into account in such investigation. Finally, early New Zealand IFRS studies are constrained by limited time frame and normally only one or two years financial data after mandatory IFRS adoption has been employed for their analysis. In contrast, I examine the effect of IFRS on conservatism using ten years' data over 2000-2009. Since 2007 IFRS mandatory adoption, three financial years' data are available for such investigation. Therefore, the results may be more rigorous than previous studies.

The remainder of this study is organized as follows. Chapter 2 reviews prior literature discusses. Chapter 3 presents New Zealand institutional framework and develops testable hypothesis. Chapter 4 describes research methodology. Chapter 5 presents and discusses the results. Chapter 6 concludes.

Chapter 2: Survey of Related Literature and IFRS Adoption in New Zealand

2.1 Accounting Conservatism as a proxy for accounting information quality

Accounting information is employed by both investors and management for decision making. Earnings information, as a primary indicator of information quality, should reflect the company's current and future financial prospects and the effects of potential uncertainties (Dechow, 1994; Dechow, Kothari, & Watts, 1998). In Dechow et al. (2010)'s commentary on earnings quality studies, it is pointed out that timely loss recognition, ongoing debated as accounting conservatism, is extensively utilised by researchers to measure earnings information quality. Therefore, this study uses accounting conservatism as a proxy for earnings quality in my investigation of IFRS effect.

Historically, accounting conservatism is defined as 'anticipation of all losses but no profit' (Bliss, 1924, p. 110). Basu (1997) interprets accounting conservatism as 'capturing accountants' tendency to require a higher degree of verification for recognizing good news than bad news...this asymmetry in recognition leads to systematic differences between bad news and good news periods in the timeliness and persistence of earnings.' (p.4) The U.S. Financial Reporting Standards Board (hereafter FRSB) defines conservatism as 'A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered' (p.10).

According to Ball et al. (2007), there are two classifications of accounting conservatism distinguished - earnings conservatism and balance sheet conservatism by prior research. Feltham and Ohlson (1995) defines balance sheet conservatism as a persistent undervaluation of shareholder equity book value. Basu (1997) interprets earnings conservatism as '...resulting in earnings reflecting 'bad news' more quickly than 'good news'. This interpretation implies systematic differences between bad news and good news periods in the timeliness and persistence of earnings.' (p.3) Another set of measurement of

two distinctive perceptions are applied for analyzing and interpreting accounting conservatism, namely conditional and unconditional accounting conservatism (Ball & Shivakumar, 2006). Unconditional conservatism is defined as the descending bias in book value of equity generated independently of news in a period (Feltham and Ohlson 1995). Conditional conservatism refers to the downward bias in earnings information arising from the asymmetric timeliness of earnings on good and bad news. Since most of the accounting standards require the instantaneous and inclusive anticipation of bad news and deferred recognitions of good news until future benefits are realized, bad news is reflected faster on reporting earnings than good news.

There are four explanations for accounting conservatism distinguished by Watts (2003) which are contracting explanation, shareholder litigation explanation, taxation explanation and accounting regulatory explanation. Contracting explanation of accounting conservatism is based on the premise the firm has a relationship of contracts among rational agents (Watts 2003). Accounting figures are employed in writing, monitoring and reinforcing contracts, such as bonus plan. Such contracts motivate managers to bias accounting figures. Problems associated with management opportunistic behaviour are mainly due to asymmetric information, asymmetric payoffs, limited horizons and limited liability. Conservative accounting can be employed as a way of addressing these moral hazard problems (Watts 2003). The existence of accounting conservatism reduces the management's incentives and ability of manipulating accounting numbers and so reduces information asymmetry between management and shareholders. Consequently, earnings quality should be increased with the decreased earnings management (Basu, 1997; García Lara & Mora, 2004; LaFond & Watts, 2008; Lyengar & Zampelli, 2010; Raonic, McLeay, & Asimakopoulos, 2004; Roychowdhury & Watts, 2007).

It is argued that higher accounting information quality would be accompanied by higher conservatism and less information asymmetry (Watts, 2003). Basu (1997) points out accounting conservatism results in a contemporaneous recognizing more current value relevant news in earnings and leaving less current value relevant news in future earnings. LaFond and Watts (2008) argue that Information asymmetry between informed insiders

(management) and uninformed investors creates a demand of conservatism even in the absence of accounting-based debt and compensation contracts, shareholder litigation, regulation and taxation. They contend that information asymmetry generates conservatism and is positively related to accounting conservatism. The larger the information asymmetry between management and external investors, the more conservatism exists in financial reports. For instance, external investors demand more conservatism earnings as a means of mitigating agency problems. Absent conservatism, managers can circumvent debt covenant constraints by simply asserting more unverifiable gains (LaFond & Watts, 2008; Watts, 2003). Therefore, accounting conservatism plays a vital role in mitigating information asymmetries and enhancing the quality of communication with outside parties in share markets characterized by dispersed ownership structures (Watts, 2003), and it is believed that the higher magnitude of accounting conservatism, the better earnings quality is.

However, it is not free of controversy that accounting conservatism is a good proxy for information quality. It is argued that unconditional conservatism may arise 'from tax, litigation and managerial self-interest' (Cano-Rodríguez, 2010, p. 132), and it may consequently decrease accounting information quality (Ball, Robin, & Sadka, 2008). For example, unconditional conservatism may be relevant to the managers' options of different depreciation or inventory valuation methods in order to achieve their managerial and opportunistic objectives. Therefore, unconditional accounting conservatism may bias accounting information quality and lead to inefficient economic decisions (Ball & Shivakumar, 2005). Only conditional conservatism enhances contracting efficiency due to its connection to disclosures of accounting information that is difficult to verify (Basu, 2005). For instance, conditional conservatism arises in goodwill impairment, as required by IAS 36 'Impairment of Assets', entity's assets are carried at no more than their recoverable amount. If the assets are carried at more than their recoverable amount, the entity needs to recognize it as an impairment loss. Therefore, conditional conservatism increases contracting efficiency (Iatridis, 2011). Moreover, conditional conservatism is desired by outside shareholders because it provides a clear view of the firms' weaknesses and strengths and assists in their decision making (Guay & Verrecchia, 2007). Finally, conditional conservatism is evident especially in the

case of high quality accounting information being required, for instance cross-listing, or in common law countries where strong investor protection mechanisms are in place (Ball et al., 2000; Bushman & Piotroski, 2006). In short, conditional conservatism is economically relevant in reducing information asymmetry and is associated with earnings quality, so I focus on conditional conservatism in this study.

In addition, overstating company net assets/earnings will trigger shareholder litigation rather than understating company net assets/earnings (Watts 2003a). Therefore, accounting conservatism mitigate the risk of litigation (Ball et al., 2000; Givoly & Hayn., 2000; Pae, 2007; Watts, 2003). Since taxation and financial reporting are associated, it can also create conservatism in financial reporting. Applying conservatism, present value of tax is reduced if financial statements coincide with tax reports (Watts, 2003). Regulation setters have their own incentives to adopt conservatism and understate company net assets/earnings to avoid criticism from overstating (Watts, 2003). Gotti (2008) argues that conservatism is adopted by regulators to reduce exposure to reputational damage caused by overvaluation of company value/income due to accounting standards.

Apart from the literature mentioned above, a sizable number of previous studies suggest accounting conservatism is influenced by legal, political environment and financial reporting incentives (Ball et al., 2007; Ball et al., 2000; Bushman & Piotroski, 2006; Habib, 2007). Ball et al.(2000) investigate the difference in asymmetric timeliness and accounting conservatism and conclude timeliness and accounting conservatism of earnings are more profound in common law countries than code law countries. Bushman and Piotroski (2006) identify the effect of country-level institutional properties on accounting conservatism. They suggest i). Accounting conservatism is positively related to quality of the national legal system. ii). Accounting conservatism is negatively related to risk of expropriation by the state ownership. iii). There are mixed and uncertain results on effect of financial architecture and tax regime on accounting conservatism.

2.2 International Financial Reporting Standards (IFRS), accounting information quality and conservatism

IFRS is the accounting framework and standards established by the IASB in UK. All the listed companies' simple or consolidated accounts were required to adopt IFRS by the European Union (EU) Parliament since 2005. IFRS adoption in Continental Europe represents a major change which is a replacement of stakeholder-oriented accounting regulations by market-oriented standards heavily influenced by the Anglo-Saxon accounting model. In August 2008, the U.S. Securities and Exchange Commission announced a Roadmap, including a timetable for voluntary adoption in large US companies in 2009, and a timetable that requires use of IFRS by all US-domiciled registrants by 2014. Following the EU, New Zealand started to mandatorily adopt IFRS in 2007 with an option of voluntary adoption in 2005.

One of the purposes of IASB is to develop a globally acceptable set of high quality financial reporting standards. To accomplish this goal, IASB has issued principles-based standards (IFRS), and taken steps to reflect the 'true and fair value' of reporting entities by removing allowable accounting alternatives (Barth et al., 2008). Arguably, implementing IFRS has the benefit of reducing information asymmetry, earnings management and cost of capital and providing more value relevant financial information to investors/shareholders (IASB, 2005). However, previous studies offer mixed results about whether IFRS adoption improves accounting quality and the benefits and costs of IFRS adoption is still open for discussion. Some of empirical accounting research documents evidence suggesting that adoption of IFRS has numerous noticeable economic consequences. In general, these studies conclude that earnings quality has improved after the adoption (Barth et al., 2008; Bartov, Goldberg, & Kim, 2005; Eva K Jermakowicz, Prather, & Wulf, 2007; Leuz & Verrecchia, 2000; Platikanova & Nobes, 2006; Shi & Kim, 2007). Figure 1 provides a comprehensive summary on recent IFRS-effect literature.

[Insert Figure 1 Here]

Specifically, literature suggests that adopting International Financial Reporting Standards (IFRS) leads to the reduction in information asymmetry between management and shareholders. Leuz (2003) and Platikanova and Nobes (2006) examine the firms in Germany's Neuer Market and European firms which adopted IFRS and conclude that companies adopting IFRS exhibit smaller bid-ask spreads than those using German GAAP. It is also suggested that adoption of IFRS improves transparency and comparability of financial reporting, reduces information asymmetry between insiders and outside minority shareholders (Leuz & Verrecchia, 2000; Leuz, 2003 & Barth et al., 2008). Hodgden et al. (2008) argue that conformity with the disclosure requirements of IFRS reduces information asymmetry and financial analysts' forecast accuracy is enhanced.

Furthermore, it is reported that value relevance of earnings is increased and earnings management is declined following IFRS adoption. Barth et al. (2008) examine 1,896 firms across 23 countries and suggest that firms applying IFRS exhibit more value relevant accounting figures than other companies without applying IFRS. In the post-adoption period, firms applying IFRS evidence less earnings management and more timely loss recognition. Bartov et al. (2005) and Jermakowicz et al. (2007) investigate German companies and argue the value relevance of IFRS-based earnings is higher than that of German GAAP-based earnings. The value relevance of earnings is higher for German DAX-30 companies using IFRS or US GAAP. Horton et al. (2008) suggest the changes in earnings information are more value relevant between UK GAAP and IFRS including share-based payments related earnings adjustments, deferred tax and goodwill amortisation. However, Jeanjean and Stolowy (2008) investigate the magnitude of change on earnings management in Australia, France and UK and argue the pervasiveness of earnings management is not declined after the adoption of IFRS, and in fact increased in France.

Finally, it is suggested that the cost of equity capital is lower for companies adopting IFRS compared to companies without adopting IFRS (Daske et al., 2008; Ernstberger & Vogler, 2008; Shi & Kim, 2007). Using 70,854 firm-year observations across 25 countries, Daske et al. (2008)

document a decrease in firms' cost of capital and an increase in equity valuations after IFRS adoption. Moreover, the capital-market benefits arise only in countries where firms have incentives to be transparent and where legal enforcement is strong. Ernstberger and Vogler (2008) examine the impact of voluntary adoption of IFRS on the cost of equity capital in Germany and suggest there is a reduction in cost of capital and the cost of equity capital effects are different within the sub-periods of the 1998–2004 voluntary-adoption period. McAnally et al.(2010) investigate equity-based compensation in 1,673 U.S. sample and conclude future cash flows can be better predicted under IFRS tax items and IFRS improves the relevance and quality of accounting information.

However, some studies report that IFRS adopters do not show improved reporting quality. For example, van Tendeloo and Vanstraelen (2005) indicate diverse earnings management performance under IFRS reporting compared to under German GAAP and companies adopted IFRS do not decrease income smoothing (Paananen & Lin, 2009). In addition, Hung and Subramanyam (2007) find that IFRS adoption has no consequence on the value relevance of book value and net income. Gjerde et al. (2008) also find there is no significant improvement in value relevance for 145 listed companies after applying IFRS. Goodwin and Ahmed (2006) provides Australian's evidence that there is no evidence showing IFRS earnings are more value relevant than under Australian GAAP due to the factor that Australia is one of the Common-law country.

Several New Zealand IFRS studies show there is no significant improvement in value relevance after IFRS adoption which is consistent with Goodwin and Ahmed (2006)'s results (Kabir et al., 2010; Rainsbury et al., 2008; Stent et al., 2010). Bridges (2009) finds no evidence that voluntary adopters of NZIFRS provide more value relevant accounting information compared to that under New Zealand local GAAP. Stent et al. (2010) analyze the effect of New Zealand International Financial Reporting Standards (NZIFRS) on listed companies' financial statements and ratios used for financial analysis. They find that 87 percent of firms are affected by NZIFRS to some extent. However, for most of the companies, the impact of NZ IFRS is small. Rainsbury et al. (2008) conclude that IFRS has little impact on the association between earnings and market value of equity and there is even a marginal decline in value relevance.

Kabir et al. (2010) compare absolute discretionary accruals under NZ IFRS with those under pre-IFRS NZ GAAP. They fail to find a significant improvement in earnings quality proxied by discretionary accruals after the adoption of IFRS. However, Cheong et al. (2010) investigate intangible capitalisation under IFRS and New Zealand Financial Reporting Standards (hereafter NZ FRS) and conclude that the adoption of IFRS provides more value relevance information in financial statements. Balshaw and Lont (2010) report that IFRS adoption improves the disclosure of operating expenses. Therefore, the results on economic consequence of IFRS adoption in New Zealand are mixed.

A few studies have been conducted on the effect of IFRS on accounting conservatism predominantly in continental Europe. Hellman (2008) explores how accounting conservatism is applied under IFRS. Three cases related to IFRS are examined in this research including judgment related to the recognition of deferred tax receivables regarding loss carry-forwards (IAS 12); judgment with regard to the capitalisation and impairment of development costs (IAS 38), and judgment regarding the use of the percentage of completion method and the zero recognition method during the completion of construction contracts (IAS 11). The author suggests that the lower stress on consistent conservatism ³ under IFRS will be substituted by an amplified employment of temporary conservatism. The temporary appliance of the conservatism principle (changes in accounting estimates) indicates that profits will initially be understated, which leads to the creation of a hidden reserve or to excessive provisions, followed by a subsequent overstatement of profits in later periods. García Lara et al. (2008) analyses whether companies' adoption of IFRS affects the conservatism of earnings. Earnings conservatism is compared between 66 New Zealand firms using New Zealand GAAP during the periods of 1988-2000. They conclude that earnings conservatism is more pronounced in common-law-based developed economies and the voluntary IFRS adopters in Europe (prior to 2005) have considerably increased the measures of earnings conservatism.

³ Hellman (2008) defines consistent conservatism as "consistent understatement of net assets" and temporary conservatism as "changes in accounting estimates that temporarily understates net assets via the creation of hidden reserves which later may be reversed". His analyzes deferred tax receivable, development cost and construction contracts treatment and finds consistent conservatism is replaced by temporary conservatism in financial reporting. Companies will apply conservatism when they make judgments regarding probabilities and other estimates.

However, Piot et al. (2010) examine 5,464 IFRS adopters from 22 EU countries over the period 2001-2008 and argue that conditional conservatism, as proxied by the symmetric timeliness and timely loss recognition, has decreased under IFRS. Moreover, the magnitude of IFRS effect for sampled countries is positively associated with the difference between IFRS and local GAAP. Finally, they conclude the EU-wide IFRS mandatory adoption has hampered accounting quality based on their findings.

In New Zealand, Kabir et al. (2010) fail to find a significant improvement in earnings quality proxied by discretionary accruals after the adoption of IFRS. However, his sample size is relatively smaller. Moreover, as Dechow et al.(2010), the proxy of residuals from accrual models is jointly used in testing earnings management and correlated omitted variables associated with fundamentals, especially performance are the major limitation of this measurement. Bridges (2009) also conducts an analysis on the conservativeness of net income measured under NZIFRS, and finds that there is no significant difference in the timeliness or asymmetric timeliness (i.e., conditional conservatism) between net income figures calculated under NZIFRS and domestically produced NZFRS. Her sample period is 2005-2007 and sample firms are only voluntary adopters. Due to such limitations in sample period and sample firms in her investigation, the research issue of whether accounting conservatism has been improved after IFRS adoption is worthy of further inquiry in a long period post-IFRS adoption.

Chapter 3: New Zealand Institutional Environment and Hypothesis Development

This chapter discusses background of IFRS adoption and relevant institutional environment in New Zealand before developing testable hypotheses.

New Zealand accounting systems have the following characteristics, i) Micro-fair-judgemental and commercially driven; ii) Business practice, professional rules and British origin; iii). UK influenced and professional regulated (Doupnik and Perera (2007). New Zealand Conceptual Framework was issued by the FRSB of New Zealand Institute of Chartered Accountants (NZICA) and approved by Accounting Standards Review Board (ASRB) in July 2004 under the Financial Reporting Act 1993. The NZ Framework summarizes the concepts which strengthen financial information presented in general purpose financial statements, and in non-financial information incorporated in or accompanies the financial statements. It has been employed by the FRSB in developing local NZ FRS and in the process of converging with International Financial Reporting Standards (NZICA, New Zealand Preface).

An announcement was issued by the Accounting Standards Review Board (ASRB) dated on 19 December 2005 requires reporting entities in New Zealand will mandatorily adopt IFRS for periods commencing on or after 1 January 2007, with the option to adopt IFRS voluntarily early from 1 January 2005 (Hickey, Spencer, van Zijl, & Perry, 2003a). Concerning the high cost of transition for small and medium-size businesses and overweight IFRS advantage, the Minister of Commerce announced a government review of SME financial reporting which led to the ASRB to delay the adoption of IFRS for small and medium-size businesses in September 2007. In 2009, the government issued a proposal to exempt the application of IFRS for most of the SMEs.

Despite of the original aims of IFRS, there have been a certain amount of New Zealand listed companies currently raise serious concern over the appropriateness of adopting IFRS. As reported by Gaynor (2010), New Zealand investors are experiencing an accounting crisis because a lot of domestic

companies have refused many of the international financial reporting standards and are stating "adjusted", "underlying", "operating", "excluding non-trading" and "from continuing operations" profits that diverge extensively from audited IFRS-compliant profits. The author compared 15 New Zealand listed companies and found the boards of the 15 listed companies consider their companies to have had combined net profits after tax of \$1,140 million for the 2010 financial year, compared with IFRS-compliant profits of \$846 million.

Although NZFRS and IFRS share the same shareholder-orientated approach and are similar in general, there are differences existed as summarised by Bradbury and Van Zijl (2005). The two major differences are i) the different treatment of income tax and accounting for revaluation changes to property, plant and equipment; ii) the absence of certain standards in NZ FRS compared to IFRS. For instance, there are no standards in relation to employee benefits (NZ IAS 18), intangibles (NZ IAS 39) and share-based payment (NZ IFRS 2) in NZ FRS (Bradbury & Van Zijl, 2005; Dunstan, 2002).

Especially, there is more mandatory disclosure required by IFRS compared to NZ FRS. For example, additional disclosures are demanded by NZ IAS-1 regarding government assistance, judgements and key sources of estimation uncertainty and operating expense⁴. There are no specific requirements in previous NZ FRS. Arguably, those compulsory disclosures keep outsider investors well informed, mitigate the agency problem and ensure more value relevant financial information to be supplied by management. Lont (2002) reports there are 64 per cent of New Zealand companies ignored operating expense disclosure requirements (NZ FRS 9) altogether. Balshaw and Lont (2010) indicate there is a significant enhancement (14 percent) was found in unspecified disclosure levels for the companies using the New Zealand equivalent to international accounting standard (hereafter NZ IAS). Dunstan

⁴ NZ IAS-1 requires a full disclosure on government assistance under the section of criteria of income recognition. Government assistance should not be recognized until there is reasonable assurance. Furthermore, relevant judgments and key sources of estimation uncertainty need to be disclosed to assist investors' evaluation of the possible risk of company assets and liabilities. Finally, NZ IAS-1 also requires a full disclosure of expenses. Expenses must be disclosed by nature or function. Cost of sales must be disclosed if the function method is selected. However, there are no specific requirements in NZ FRS regarding those mentioned disclosure requirements.

(2002) argues IFRS, a viable alternative of NZ FRS, will benefit New Zealand in a long timeframe. Based on previous literature and comparison between IFRS and NZ FRS, it is predictable that compare to previous NZ FRS, IFRS have more tightened requirements on both quantity and quality of financial information provided to outside shareholders which can reduce information asymmetry and increase earnings quality correspondingly.

New Zealand is one of the five Anglo-Saxon countries and has the common law legal system. Unlike previous studies conducted in the EU code law countries that the accounting standards are laid down in laws and regulations by the nominated deputies, the common law system is characterized by the existence of formal institutions which are more likely to reinforce regulations and rules to protect minority shareholders' interest (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; North & Weingast, 1989). However, being unparalleled with other common law countries' enforcing controls on Stock Exchange's regulation, the New Zealand Exchange has developed a self-regulated model (Peare, 1999). Previous New Zealand studies indicate the enforcement of New Zealand law is argued to be less rigorous and investors' litigation cost is higher than it is in the United States (Clarkson & Simunic, 1994; Hossain, Ahmed, & Godfrey, 2005; Mak, 1996). Facing modest litigation threat, listed companies may not disclose up to a high standard level. Especially, management may withhold information or delay the recognition of loss for certain economic incentives which increases the information asymmetry between inside and outside shareholders.

Compared to other common law countries, for example UK and USA, New Zealand has a higher concentrated ownership, and those major shareholders are mainly formed by foreign financial institutions and corporations rather than local shareholders (Bhabra, 2007). However, those foreign financial institutions' efficiency and willingness of monitoring management is comparatively weak compared to other common law countries. Bhabra (2007) concludes geographical separation from their invested companies may partially responsible for the monitoring inefficiency of those foreign financial institutions and corporations. The problem of insufficient disclosure arises due to the weak monitoring efficiency and less demand of financial information by foreign

financial institutions. Consequently, it leads to relevant low quality of earnings information. Empirically, Jiang and Habib (2009) find that New Zealand listed companies controlled by financial institutions make significantly fewer voluntary disclosures. In addition, Balshaw and Lont (2010) argue both NZ FRS and IFRS mandatorily require a full disclosure of operating expenses, for example depreciation, directors and auditors fee. However, the unspecified operating expense disclosure is comparatively poor under NZ FRS.

After IFRS adoption, New Zealand companies are mandatorily required to compliance with the relevant higher quality accounting standards. As previous literature discussed, IFRS improves transparency and comparability of financial reporting, reduces information asymmetry between insiders and outside minority shareholders (Leuz & Verrecchia, 2000; Leuz, 2003 & Barth *et al.*, 2008). Furthermore, New Zealand companies are mandatorily required to conduct more disclosure under IFRS than NZ FRS which benefits both major shareholders and minority shareholders. A substantial improvement is found in unspecified disclosure levels after the adoption of NZ IAS (Balshaw & Lont, 2010). Hence, it is expected the quality of the financial information should be improved and the information asymmetry is reduced between management and outside investors. Furthermore, I conjecture the magnitude of conditional conservatism should be higher than pre-adoption period. Based on the proceeding discussions, the following hypothesis is stated:

H1: Accounting conservatism is increased after the adoption of IFRS in New Zealand.

A few recent New Zealand studies are conducted to investigate the effect of IFRS. They conclude that there is no significant evidence that IFRS improves accounting information quality. However, most of these studies are constrained by relatively limited timeframe and mainly use sample of only voluntary adopters (Balshaw & Lont, 2010; Bridges, 2009; Cheong *et al.*, 2010; Rainsbury *et al.*, 2008; Stent *et al.*, 2010).

Most of the New Zealand listed companies were mandatorily required to compliance with NZ IAS in 2007. Compare to voluntary adopters, mandatory adopters are more likely to have significant changes in their financial reporting

practices. Daske et al. (2008) argue that voluntary adopters are positive adopters while mandatory adopters are passive. Voluntary adopters are most likely to have implemented good accounting practices before IFRS adoption. In addition, voluntary adopters may have greater willingness to adopt IFRS and therefore experience a significant impact of IFRS on their disclosure quality and share market effect (Daske et al. 2008; Horton et al. 2008; Krivogorsky et al. 2010). Therefore, the impact of New Zealand voluntary adopters needs to be considered. In contrast, mandatory adopters may need to utilize broaden strategies to increase their commitment to more transparency, for instance, hiring higher quality auditors, improving corporate governance and seeking cross-listings in stricter regimes. Additionally, more disclosure is required by NZ IAS than NZ FRS. Consequently, it is predictable that the information asymmetry between mandatory adopters and their information users are more likely to be reduced after high quality accounting information is produced according to IFRS. Daske et al. (2008) report the capital-market effects of IFRS are particularly pronounced for voluntary adopters and institutional environment plays crucial role in reporting outcomes. However, the empirical results can hardly generalized into New Zealand because there is no New Zealand institutional characteristics are considered in this study. If this argument holds, there will be an increase on accounting conservatism for mandatory adopters showing a larger effect of IFRS on earnings quality.

There are approximate 34 New Zealand companies voluntarily adopted IFRS in 2005 and 2006. They are either cross-listed or have significant overseas investment. Tarca (2004) points out that early IFRS adopters usually have characteristics such as foreign stock exchange listing. The sample of Daske et al. (2008) indicates 3 percent of New Zealand listed companies were US listing in 2005. Frijns et al. (2008) show New Zealand and Australian share markets are closely connected. There are significant New Zealand listed companies cross listed in Australia such as Auckland International Airport (AIA), Telecom (TEL), the Warehouse (WHS), Tower (TWR), Fletcher Building (FBU) that are traded on both the ASX and NZX. Those cross-listing companies are more likely to adopt IFRS voluntarily to be benefited from different share markets. Based on above discussion, it is predicted that voluntary adopters have differential incentives to adopt IFRS earlier than other companies.

Moreover, most recent NZ IFRS studies have failed to find significant beneficial effect of IFRS using voluntary adopters as their sample (Bridges, 2009; Rainsbury et al., 2008). I argue that the incremental effect of IFRS on conservatism does not exist for voluntary adopters. In this case, I would observe a larger IFRS effect on conservatism only for mandatory adopters and such incremental effect of IFRS on conservatism will not be observed for voluntary adopters. Based on the preceding discussion, the following hypothesis is formulated.

H2: Accounting Conservatism is higher for mandatory adopters after adoption of IFRS; accounting conservatism is not different for voluntary adopters after adoption of IFRS.

Chapter 4: Research Methodology

4.1 Research Design

There is a variety of measures of accounting conservatism. However, the consistency among those measures is lacking (Wang, Zijl, & hÓgartaigh, 2009). Five key measures of accounting conservatism have been summarised by Wang et al. (2009), and there are vital problems with each of these five measures.⁵ Although Basu's model is argued of showing poor performance in time-series research and there is a simultaneity problem in the association between earnings and stock returns, in the 52 papers reviewed by Wang (2009), 36 have used Basu's model, which makes Basu's model the most popular model for investigating accounting conservatism in the literature. Therefore, following main stream of accounting conservatism studies, I apply Basu (1997)'s model. This proxy measures the incremental response to bad news relative to good news. To test hypotheses, I apply Basic Basu's model in equation (1) into two sub-sample periods, including pre-adoption period of 2000-2006 and post-adoption period of 2007-2009. Equation (1) is as follows.

$$\frac{EPS_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} \times DR_{it} \quad (1)$$

Where, EPS_{it} represents the earnings per share for firm i in fiscal year t ; $P_{i,t-1}$ is the price per share of firm i at the beginning of the fiscal year $t-1$; R_{it} represents the return on firm i from 9 months before fiscal year-end t to 3 months after fiscal year end t ; DR_{it} represents a dummy variable with a value 1 if R_{it} is negative, and 0 otherwise.

Equation (1) is tested on two sub-sample groups, including pre-adoption group with firm-year observations during 2000-2006 and post-adoption group with firm-year observations during 2007-2009. The incremental response to bad news relative to good news is captured by β_1 . Under conservative reporting, β_1 is expected to be positive. The ratio of $(\beta_0 + \beta_1) / \beta_0$ is expected to be more

⁵ For a comprehensive analysis and criticism on those accounting conservatism measures, see Wang et al. (2009).

than one, and gauges the relative sensitivity of earnings to bad news compared with earnings sensitivity to good news.

The relative explanatory power of regression (1) in periods of bad news (negative returns) and good news (positive returns) is assessed by the ratio of the R^2 in bad news periods to the R^2 in good news periods. Under conservative reporting, this ratio is expected to be greater than one (Givoly and Hayn, 2000). The β_1 is expected to be significantly larger during 2007-2009 period than pre-adoption period, and the ratio is significantly larger in post-adoption period than pre-adoption period.

An alternative approach is employed to test the effect of IFRS on conservatism level. Equation (2) is a modified Basu's model for such purpose.

$$\frac{EPS_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 IFRS_{it} + \alpha_3 DR_{it} \times IFRS_{it} + \beta_0 R_{it} + \beta_1 R_{it} \times DR_{it} + \beta_2 R_{it} \times IFRS_{it} + \beta_3 R_{it} \times DR_{it} \times IFRS_{it} \quad (2)$$

Where IFRS equals 1 for observations for observations acquired after the adoption of IFRS post-adoption), and 0 for observations obtained before the adoption (pre-adoption). The variable of IFRS is adjusted based on the actual adopting year (either in 2005 or 2006) for voluntary adopters. Other variables are the same as previously defined in equation (1). Equation (2) is tested on pooled sample observations during 2000-2009. The variables of interest in equation (2) are $\beta_3 R_{it} \times DR_{it} \times IFRS_{it}$. The interactive slop coefficients β_1 and β_3 measure the earnings incremental response to bad news relative to good news pre- and post-IFRS adoption respectively. Therefore, observing $\beta_3 > 0$ will be consistent with my hypothesis 2 suggesting a greater asymmetric timeliness of earnings post IFRS adoption compared to pre-adoption.

4.2 Sample selection and data source

The sample for this study is selected from listed companies traded on the NZSX and NZAX Share Markets over 2000-2009 periods. NZSX is the Main Board of NZX and is NZX's premier equities market, while NZAX is

particularly set up for fast-growing, developing companies, small to medium sized and non-standard companies to facilitate efficient capital financing.

To provide more insight into this research, sample period from 2000-2009 is selected in empirical equation (1) and (2) to capture the effect of IFRS implementation on the magnitude of accounting conservatism. Both pre-adoption and post-adoption periods are covered because New Zealand listed companies were mandatorily required to adopt IFRS in 2007. Due to the unavailability of 2010 financial information at the start of this research, listed companies' 2010 financial data is not included in this research. Finally, financial institutions such as investment banks, pension funds, mutual funds, money managers, investment funds, commercial trusts, endowment funds, hedge funds and insurance companies listed on NZX are excluded due to the different reporting requirements outlined by NZIAS. My final sample consists of 771 firm-year observations representing 97 New Zealand listed companies. The sample derivation is shown in Table 1 Panel A and an industrial breakdown of sample is illustrated in Panel B. There are 30 New Zealand voluntary adopters in the sample which are listed in Table 2.

[Insert Table 1 Here]

[Insert Table 2 Here]

Chapter 5: Empirical Results

In this chapter, I present the results of the main analysis and relevant discussion on the findings of this study.

5.1 Descriptive statistics

Table 3, Panel A presents descriptive statistics for the main variables in the study. The mean of the deflated earnings per share ($EPS = \frac{EPS_{it}}{P_{it-1}}$) is 2.4483 with a minimum value of -29.7978 and maximum of 28.6989. To treat outliers, EPS data has been winsorized at the 1st – 99th percentiles. The returns (R) have a mean of 0.0851 with a maximum of 4.09, a minimum of -0.90 and standard deviation of 0.41115. Panel B indicates there is no significant correlation (R value is 0.270 and significant at .000 level) between EPS and R applied in both equations (1) and (2).

Table 3, Panel B shows descriptive statistics on firm size and capital structure of samples divided into voluntary and mandatory adopting groups. Firm size is calculated based on sample firms' total assets and Capital Structure is measured by Ownership Concentration. The mean of firm size for mandatory adopters is 477,641 and the ownership has a mean of 52.62% with a standard deviation of 51.56. Compare to mandatory adopters, voluntary adopters have relatively bigger firm size and higher ownership concentration with a mean of 820,332 and 59.61% respectively.

[Insert Table 3 Here]

5.2 Analysis of regression equations

5.2.1 The timeliness of earnings with respect to bad/good news in pre- and post-IFRS adoption periods

The results of regression equation (1), applied Basu (1997)'s model to estimate the timeliness of earnings with respect to bad/good news, are presented in Table 4. The regression analysis is respectively conducted for two groups of pre- and post-adoption sub-samples. The coefficients of variable $R_{it} \times DR_{it}$, C and DR_{it} are expected to be positive. In addition, the ratios of $(\beta_0 + \beta_1) / \beta_0$ are expected to be more than one, suggesting the relative sensitivity of earnings to bad news compared with earnings sensitivity to good news. As presented in Panel A, the analysis on pre-adoption shows that the coefficients of C and DR are both positive as expected; $R \times DR$ is statistically significant with a positive coefficient (β_1) of 49.11 and the earnings is about twenty times $([2.57 + 49.11] / 2.57)$ as sensitive to negative returns as it is to positive returns for the pre-adoption period. This suggests the existence of accounting conservatism in listed companies before the adoption of IFRS.

[Insert Table 4 Here]

The results of the regression conducted on post-adoption group, as listed in Table 4 Panel A, suggest that accounting conservatism in post-adoption period is evidenced by the positive coefficient (β_1) of 64.23. In addition, as shown in Panel B, an F-statistics is conducted to compare the significance of the difference between β_1 s of pre- and post-adoption periods. F-test is 59.107 and is significant at better than 1% level, suggesting that the coefficient (β_1) in post-adoption period is also statistically and significantly bigger than pre-adoption's coefficient (β_1) on $R \times DR$ of 49.11. Thus, the results show that the accounting conservatism is significantly increased after the IFRS adoption in New Zealand, and this increase is statistically significant. Therefore, our hypothesis one is supported. The adjusted R^2 s are 0.16 and 0.21 and the F-value are 31.11 and 21.68 for pre- and post-adoption periods respectively which are similar to Basu (1997)'s results.

5.2.2 IFRS effect on accounting conservatism

For equation (2), Basu (1997)' model is modified by adding a new variable - IFRS in. IFRS equals 1 for observations acquired after mandatory adoption of IFRS (2007-2009) and 0 for observations obtained before mandatory adoption (2000-2006). I expect that the coefficient of $R*DR*IFRS$ (β_3) is statistically significant and positive. Table 5 Panel A presents the result of regression equation (2) using all firm-year observations during 2000-2009. The coefficient of $R*DR*IFRS$ is positive as expected (coefficient 15.13). However, it is not statistically significant (t-statistics 1.39), which is not consistent with my prediction. This insignificant coefficient on $R*DR*IFRS$ suggests there is no significant change in the magnitude of accounting conservatism after the adoption of IFRS.

[Insert Table 5 Here]

As discussed in chapter 3, voluntary adopters may have different incentives and characteristics from mandatory adopters in adopting IFRS. To investigate the effect of IFRS on conservatism, voluntary adopters should be considered. I separate the data into two groups, namely voluntary adopters and mandatory adopters. Equation (2) is then analyzed on firm-year observations of voluntary adopters and mandatory adopters respectively. Table 5 Panel B presents the results of equation (2) analysis using only mandatory adopters' firm-year observations over 2000-2009. The coefficient of $R*DR*IFRS$ (32.65) is statistically significant (t- statistic -2.62 and significant at better than 1 percent level). It indicates that accounting conservatism is considerably improved for mandatory adopters after IFRS adoption.

The results of regression analysis using equation (2) with voluntary adopters' data are shown in Panel C. For this analysis, IFRS takes value 1 for firm-year observations of voluntary adopters for the year in which they started voluntary adoption (2005 or 2006) and the years after, and 0 for the observations in early years. The results show that the β_3 is -54.12 with a negative t-statistic -2.17 (significant at 5 percent level). The results demonstrate

that after IFRS adoption, voluntary adopters have experienced a decrease in conservatism. The results in panel B and C of Table 5 suggest that accounting conservatism is improved for mandatory adopters after firms adopt IFRS, but not for voluntary adopters. Thus, the results provide supportive evidence for hypothesis two. The adjusted R-square and F-value are 0.18 and 7.37 respectively indicating the general fitness of this model.

5.3 Discussion

In this study, I find accounting conservatism exists for both pre- and post-adoption of IFRS. Furthermore, I report accounting conservatism is significantly increased after the IFRS adoption by adopting Basu (1997)'s model with the full sample data. This indicates that accounting information quality is improved after the adoption of IFRS because of the enhancement of conservatism. My finding is contrast to Piot (2010)'s result suggesting conditional conservatism has decreased after the adoption of IFRS within Europe.

I interpret this finding as follows. First, compare to NZ FRS, IFRS offers higher-quality accounting information due to there is more conditional conservatism is required under IFRS. Increased conditional conservatism reduces information asymmetry between inside and outside shareholders leads to a sufficient transparency for outside investors to make informed decisions. Second, there is more mandatory disclosure required by IFRS compared to NZ FRS. Higher quality earnings information is required by IFRS and accounting conservatism should be improved accordingly. New Zealand companies are mandatorily required to conduct more disclosure under IFRS than NZ FRS. Considering New Zealand institutional environment as discussed in chapter three, a substantial improvement should be found in unspecified disclosure levels after the adoption of IFRS which benefits most of the shareholders especially minority shareholders.

After conducting a supplementary analysis, I find the impact of IFRS on conservatism for mandatory adopters is significant suggesting there is a substantial improvement in earnings quality after IFRS adoption for mandatory

adopters. However, my result suggests that accounting conservatism is not improved for voluntary adopters. The incremental effect of IFRS on conservatism does not exist for voluntary adopters. This may be due to the fact that those voluntary adopters have had greater earnings quality in their financial reporting and have implemented good accounting practices before IFRS adoption. Daske et al. (2008) argues voluntary adopters are more likely to be transparent and have incentives of adopting IFRS earlier than mandatory adopters. The capital market effects are more pronounced for voluntary adopters and their disclosure level is relatively high before IFRS adoption. Based on Daske et al. (2008)'s argument and my finding, it is indicated that New Zealand voluntary adopters may have relatively better quality financial information disclosed than mandatory adopters before IFRS adoption. Therefore, conservatism is not improved after the adoption of IFRS for voluntary adopters. On the other hand, mandatory adopters are those passive adopters, who may have lower earnings quality before IFRS adoption (Daske et al. 2008). In order to meet the requirement of IFRS, they may have to improve accounting information system, disclose more relevant information and reduce information asymmetry between inside and outside shareholders. Thus mandatory adopters experience a noteworthy improvement in reporting quality after IFRS adoption.

My overall result for voluntary adopters reinforce previous New Zealand studies' (Bridges, 2009; Kabir, Laswad, & Islam, 2010; Rainsbury, San Diego, & Lyndon, 2008) that there is no difference on accounting conservatism in firms that voluntarily adopted IFRS in New Zealand. However, the result for mandatory adopters shows accounting conservatism is higher for mandatory adopters after adoption of IFRS which can be possibly explained through various proxies are deployed. Bridges (2009) studies the impact of IFRS by applying asymmetric timeliness of income. However, only thirty two voluntary adopters are analysed. Rainsbury et al. (2008) examine the association of earnings and equity with market values and conclude there is a marginal decrease in value relevance after the adoption of IFRS. Though, the study is constrained by relatively limited timeframe (2005-2008). Kabir et al. (2010) fail to find a significant improvement in earnings quality proxied by discretionary accruals after the adoption of IFRS. My study differentiates Kabir et al. (2010) with employing different proxy and longer timeframe. Dechow et al. (2010)

points out there is no exclusive conclusion on earnings quality because “quality” is contingent on the decision context. Applying diverse proxies or measurements will possibly reach different results. My study examines earnings quality through gauging the changes in timely loss recognition (conditional conservatism) in New Zealand pre- and post-adoption of IFRS. As a result, my findings differ from other prior New Zealand studies.

There are a few limitations of analysis in my study. The weaknesses of Basu (1997)’s model have been well debated by researchers. For example, Basu (1997)’s model has simultaneity problem in the relationship between earnings and stock returns (Wang et al., 2009). In addition, Basu (1997) indicates that the net effect of timely loss recognition (TLR) is unclear because TLR leads to lower persistence during bad news periods than during good news periods. Both persistence and TLR affect the decision usefulness of earnings (Dechow et al., 2010). Due to such limitations, drawing inference from Basu’s model on accounting information quality should be carried out with caution. Moreover, Basu’s model is used to test the conditional accounting conservatism in this study. Unconditional accounting conservatism has not been tackled. For a more complete study, multiple measures of unconditional conservatism, such as total accruals and book-to-market value, could be employed to improve the robustness of the results (Ahmed & Duellman, 2007; Beatty, Weber, & Yu, 2008).

Chapter 6: Conclusion

The purpose of this paper is to investigate whether IFRS adoption has a positive effect on earnings quality proxied by accounting conservatism in New Zealand. The extant New Zealand literature provides mixing results on the consequence of IFRS adoption. Using 771 firm-year observations of New Zealand listed companies over the period 2000-2009, I find the existence of conditional conservatism for both pre- and post-adoption of IFRS. Furthermore, accounting conservatism is increased after the adoption of IFRS in New Zealand. Finally, accounting conservatism is improved for mandatory adopters but not for voluntary adopters. The impact of voluntary adopters mitigates the overall effect of IFRS on conservatism in New Zealand. To the extent that accounting conservatism is economically relevant to reducing information asymmetry and contracting cost, and is thus connected to accounting information quality, my findings suggest that the adoption of IFRS in New Zealand has a positive impact on earnings quality.

This study makes contribution in several ways. First, I extend empirical literature on the accounting effect of IFRS adoption by providing specific evidence on accounting conservatism from New Zealand. Second, the IFRS effect on voluntary adopters has been differentiated from mandatory adopters in my investigation. Finally, early New Zealand IFRS studies are constrained by limited time frame and normally only one year financial data after mandatory IFRS adoption. In contrast, I examine the effect of IFRS on conservatism using ten years' data over 2000-2009. Since 2007 IFRS mandatory adoption, three financial years' data have been made available for such investigation. Therefore, the results may be more rigorous than previous studies.

Finally, this study has some limitations. Besides the weaknesses of Basu (1997)'s model discussed in previous chapters, several factors potentially affecting the effectiveness of IFRS adoption in New Zealand can be considered in future study. For instance, whether IFRS adoption improves earnings quality and corporate disclosure is, to a large extent, corporate governance issue. Effective audit committee, robust internal control, and strong board of directors,

will implement adequate monitoring and control over financial reporting. Moreover, high quality external audit can also ensure great compliance with IFRS and thus improve accounting information quality after IFRS adoption. As a result, the IFRS effect on accounting information quality may be improved as joint effect of high quality accounting standards introduced by IFRS, strong corporate governance and high quality audit. Future research can take these factors into account in research design. Thirdly, this study is conducted based on the assumption of constant legal and institutional environment. More analysis can be conducted to examine whether institutional differences between pre-IFRS and post-IFRS can affect conservatism. In addition, dual listed companies may have different incentives than other local listed companies. An extra sensitivity analysis can be conducted to test this issue. Finally, there is only one measure of accounting quality applied in this research, other measures such as discretionary accruals can be included to increase the validity and generalisability of the research.

Figure 1

Summary of IFRS Studies

Authors	Research Objective(s)	Sample	Results
<i>European, US & Worldwide Studies</i>			
Leuz & Verrecchia (2000)	The economic benefits for German companies switch from the German GAAP to IFRS	The sample consists of 102 German companies financial information from 1998-2000	Companies using IFRS show smaller bid-ask spreads than those using German GAAP
Ashbaugh and Pincus (2001)	Whether the variation in accounting standards across national boundaries relative to IAS has an impact on the ability of financial analysts to forecast non-U.S. firms' earnings accurately. Whether analyst forecast accuracy changes after firms adopt IAS.	The sample consists of 108 companies' financial data of 13 countries worldwide over the period 1990-1993	The convergence in firms' accounting policies brought about by adopting IAS is positively associated with the reduction in analyst forecast errors.
Leuz (2003)	Whether firms using U.S. generally accepted accounting principles (GAAP) vis-à-vis international accounting standards (IAS) exhibit differences in several proxies for information asymmetry	The sample consists of 2000 observations for 69 firms in German New Market over the period 1999-2000	At least for New Market firms, the choice between IAS and U.S. GAAP appears to be of little consequence for information asymmetry and market liquidity. These findings do not support widespread claims that U.S. GAAP produce financial statements of higher informational quality than IAS.
Bartov et al. (2005)	Whether the companies' financial reports under German GAAP and US GAAP provide information superior to that under IAS.	The sample consists of 3570 firm-year of 628 firms traded on German Stock exchanges over the period 1991-2000	The value relevance of U.S. GAAP- and IAS-based earnings is higher than that of German GAAP based earnings. The result holds only for profit observations, suggesting that reporting regime does not have an influence on the quality of earnings in the case of loss firms.
Van Tendeloo and Vanstraelen (2005)	Whether voluntary adoption of International Financial Reporting Standards (IFRS) is associated with lower earnings management.	The sample, consisting of German listed companies, contains 636 firm-year observations relating to the period 1999–2001.	The results suggest that IFRS-adopters do not present different earnings management behaviour compared to companies reporting under German GAAP. Voluntary adopters of IFRS in Germany are not associated with lower earnings management.
Jermakowicz et al. (2007)	The authors examine the challenges and benefits, including value relevance, of the adoption of IFRS by DAX-30 companies, the German premium stock market.	The sample consists of 265 observations of DAX-30 companies in Germany during the period 1995–2004	Adopting IFRS or US Generally Accepted Accounting Principles or cross-listing on the New York Stock Exchange significantly increases the value relevance of earnings relative to market prices.

Shi and Kim (2007)	The paper investigates whether and how the cost-of-capital effect of IFRS adoptions is differentially influenced by the efficacy of institutional infrastructures determining a country's corporate governance and enforcement mechanisms	A sample of 21,608 firm-years with International Financial Reporting Standards (IFRS) adopters and non-adopters from 34 countries over the period 1998-2004	First, the cost of equity capital is significantly lower for the full IFRS adopters than for the non-adopters irrespective of a country's institutional infrastructure. Second, the cost of capital decreases with the efficacy of institutional infrastructure. Finally, the cost of capital-reducing effect of IFRS adoption is greater when the IFRS adopters are from countries with weak institutional infrastructures than when they are from countries with strong infrastructures
Barth et al. (2008)	Whether application of International Accounting Standards (IAS) is associated with higher accounting quality	The sample comprises 1,896 firm-year observations for 327 firms that adopted IAS between 1994 and 2003	Firms applying IAS from 21 countries generally evidence less earnings management, more timely loss recognition, and more value relevance of accounting amounts than matched sample firms applying non-U.S. domestic standards.
Daske et al. (2008)	The economic consequences of mandatory International Financial Reporting Standards (IFRS) reporting around the world	The sample comprises about 35,000 firm-years from 9,000 unique firms of 26 countries, of which more than 3,100 must adopt IFRS for the first time	The results show market liquidity increases around the time of the introduction of IFRS. The authors also find a decrease in firms' cost of capital and an increase in equity valuations, but only if the possibility that the effects occur prior to the official adoption date is accounted for.
Ernstberger and Vogler (2008)	The study examines the impact of voluntary adoption of Internationally Accepted Accounting Principles (IAAP, i.e., IAS/IFRS and U.S. GAAP) on the cost of equity capital in Germany	The sample consists of 548 companies from German Stock Market over the period 1997-2005	First, overall cost of equity-capital estimates in the Capital Asset Pricing Model (CAPM) for companies applying International Accepted Accounting Principles (IAAP) are significantly lower compared to those applying German GAAP. Second, changes of the institutional background in Germany and of the accounting standards lead to different cost of equity capital effects for sub-period of the 1998–2004 as a voluntary-adoption period, while particularly controlling for effects like self-selection, cross-listing, and New Market listing.
Hodgden et al. (2008)	The paper investigates the relationship between analysts' earnings forecast errors and firm compliance with the disclosure requirements IFRS	The sample comprises of 633 firms for 13 countries during the period 1999-2000	The results suggest that compliance with the disclosure requirements of IFRS reduces information asymmetry and enhances the ability of financial analysts to provide more accurate forecasts.
Horton and Serafeim (2008)	The study investigates the effect of mandatory IFRS adoption on firms' information environment.	The sample consists of 47,209 observations of 8,124 companies from 46 countries	Compliance with IFRS reduces analyst forecast errors. Investors will benefit more from either increased comparability or higher quality information.

Goodwin and Ahmed. (2006)	The paper examines the impact of Australian equivalents to international financial reporting standards (A-IFRS) on the accounts of small-, medium- and large-sized firms.	The sample comprises 135 listed Australian entities, the half-yearly accounts ended 30 June 2005.	The results show that more than half of small firms have no change in net income or equity from Australia IFRS (A-IFRS), and that there is an increase in the number of adjustments to net income and equity with firm size. Moreover, A-IFRS has increased net income for small- and medium-sized firms. Equity has increased (decreased) under A-IFRS for small (large) firms. Small firms experience higher earnings variability than medium-sized or large firms under A-IFRS.
García Lara et al. (2008)	The study analyses whether the use of IASB standards affects the conservatism of earnings of the firms that adopt them. The authors compare the conservatism of firms by groups of firms/countries using or not IAS	The sample consists 79,052 firm-year observations acquired from 12,057 firms of 58 countries over the period 1994-2003	Earnings conservatism is more pronounced in common-law-based developed economies. The voluntary use of IAS in Europe (prior to 2005) has significantly increased the measures of earnings conservatism in adopting firms. The use of IAS fails to improve the relevance and reliability of accounting information in emerging/developing countries, where enforcement and investor protection is low.
Bissessur and Hodgson (2010)	IFRS impact on information flow in Australia	The sample consists 7,266 Australian listed firms over the period 1999-2008	Stock market synchronicity is decreased in the first two post-IFRS years and increased to a significantly higher level in later years. The analyst forecast earnings errors are low after IFRS adoption.
Paananen and Lin (2009)	The study investigates accounting quality after IFRS-adoption	The sample consists 187 firm-year observations for 107 German companies over the period of 2000-2006	IFRS adopters do not carry out less income smoothing and accounting quality has not improved but worsened over time
Hung and Subramanyam (2007)	The study investigates accounting quality after IFRS-adoption in Germany	The sample consists 80 German listed companies' financial data over the period of 1999-2002	IFRS adopters have no consequence of improving the value relevance of firms' book value and net income in Germany. There is weak evidence that IAS income shows greater conditional conservatism than HGB income
McAnally et al. (2010)	The study exams how IFRS conversion affects financial statements and the quality of reported numbers	The sample consists 1,673 U.S. listed companies' financial data over the period of 1995-2005	The future cash flows can be better predicted under IFRS tax items and IFRS improves the relevance and quality of accounting information.

New Zealand IFRS Studies			
Rainsbury et al. (2008)	The study examines the financial impact of the adoption of international financial reporting standards (IFRS) on New Zealand (NZ) companies.	The sample consists 92 New Zealand listed companies' financial data over the period 2005-2007	The adoption of IFRS has had little impact in New Zealand on the association between earnings and equity with market values and there has been a marginal decrease in value relevance.
Bridges (2009)	The change on magnitude of value relevance pre- and post IFRS adoption in New Zealand	The sample consists 34 IFRS early-adopters over the period 2004-2008	There is little evidence that the voluntary adoption of NZIFRS provides more value relevant accounting information compared to that under NZ local GAAP. Moreover, there is no significant difference in the timeliness or asymmetric timeliness (i.e., conditional conservatism) between net income calculated under NZIFRS and domestically produced NZFRS.
Kabir et al. (2010)	The paper researches on the impact of early adoption of NZ IFRS on earnings quality in New Zealand	The sample consists 723 firm-years New Zealand listed companies from 2002-2009	The results reveal non-conservative bias of NZ IFRS vis-à-vis pre-IFRS NZ GAAP. There is no statistically significant difference in earnings quality between IFRS firm-years and non-IFRS firm years, and between pre-adoption years and post-adoption years for early adopters
Stent et al. (2010)	The purpose of this paper is to examine the financial statement impacts of adopting NZ IFRS during 2005 through 2008	The sample consists 151 New Zealand listed companies from the period 2005-2008	The results show that 87 per cent of firms are affected by NZ IFRS. However, the impact for most of the firms is small. For certain companies the impact is huge.
Balshaw and Lont (2010)	The purpose of this paper is to investigate the level of compliance on the mandatory disclosure on operating expense under NZ IFRS and NZ FRS	The sample contains 94 companies adopting NZ FRS and 37 adopting NZ IFRS from 2002 to 2007	The results show the adoption of IFRS improves the disclosure of operating expense. However, the authors raise the concern that there are still 14 percent of companies using NZ IFRS do not disclose unspecified expense.
Cheong et al. (2010)	The study investigates whether financial analysts' forecast accuracy differs between the pre- and post-adoption of IFRS in the Asia-Pacific region	The sample contains 66 Australia, Hong Kong and New Zealand companies from 2001 to 2008	The results reveal IFRS adoption provides more value-relevant information in financial statements for the users of financial statements.

Table 1: Sample derivation and Industrial breakdown***Panel A - Sample derivation***

	Firms	Firm-years
Base Sample (data acquired from NZ Deep Archive, Fiscal 2000-2009)	<u>136</u>	<u>1049</u>
Elimination:		
Financial companies	23	183
Delisted companies	3	22
Overseas listed companies	2	14
Companies with share prices are not available on NZ Deep Archive	11	59
Final sample	<u>97</u>	<u>771</u>

Panel B – Industrial breakdown of sample firms and firm-year between voluntary adopters and mandatory adopters

	Voluntary Adopters		Mandatory Adopters	
	Firms	Firm-year	Firms	Firm-year
Agriculture and Fishing	1	6	9	67
Building Material & Construction	0	0	1	6
Consumer	7	60	9	62
Energy Processing	1	10	5	44
Investment & Other Services	2	19	12	82
Food and Beverage	0	0	5	26
Forestry & Forest Products	1	10	0	0
Intermediate & Durables	3	30	12	98
Leisure & Tourism	3	30	3	20
Media & Telecommunications	1	10	1	6
Mining	0	0	3	23
Ports	3	30	2	20
Property	0	0	9	76
Textiles & Apparel	0	0	1	10
Transport	0	0	3	26
	22	205	75	566

Table 2: List of voluntary IFRS adopters**List of voluntary IFRS adopters**

	Code	Name of voluntary adopters	Adoption Year
1	ABA	Abano Healthcare Group Limited	2006
2	BGR	Briscoe Group Limited	2006
3	CER	Cer Group Limited	2006
4	CEN	Contact Energy Limited	2005
5	CYT	Cynotech Holdings Limited	2005
6	EBO	Ebos Group Ltd	2006
7	FIN	Finzsoft Solutions Limited	2006
8	FBU	Fletcher Building Limited	2005
9	HBV	Hellaby Holdings Limited	2005
10	JWI	Just Water International Limited	2006
11	PHB	Life Pharmacy Limited	2006
12	LPC	Lyttelton Port Company Limited	2006
13	MHI	Michael Hill International Limited	2005
14	MCK	Millennium & Copthorne Hotels New Zealand Ltd	2005
15	NEW	New Image Group Limited	2006
16	NZR	New Zealand Refining Co Ltd	2006
17	NTH	Northland Port Corporation (NZ) Limited	2006
18	NPX	Nuplex Industries Limited	2005
19	RBD	Restaurant Brands New Zealand Limited	2006
20	SKC	Sky City Entertainment Group Limited	2006
21	SKY	Sky Network Television Limited	2006
22	SPN	South Port New Zealand Limited	2006
23	STU	Steel & Tube Holdings Limited	2006
24	TAY	Taylors Group Limited	2006
25	TTK	Teamtalk Limited	2006
26	TEL	Telecom Corporation Of New Zealand Limited	2005
27	TEN	Tenon Limited	2005
28	THL	Tourism Holdings Limited	2005
29	TUR	Turners & Growers Limited	2005
30	WFD	Wakefield Health Limited	2006

Table 3: Descriptive Statistics and Correlation Matrix**Panel A – Descriptive Statistics for variables in equation (1) & (2)**

	N	Minimum	Maximum	Mean	Std. Deviation
	Statistic	Statistic	Statistic	Statistic	Statistic
EPS	771	-29.7978	28.6989	2.4483	16.5546
R	771	-.90	4.09	.0851	.41115

Panel B – Correlation for variables of equation (1) and (2)

		R	EPS
R	Pearson Correlation	1	.270
	Sig. (2-tailed)		.000
	N	771	771
EPS	Pearson Correlation	.270	1
	Sig. (2-tailed)	.000	
	N	771	771

Panel C – Descriptive Statistics on Firm Size and Capital Structure

	Full Sample			Voluntary Adopters			Mandatory Adopters		
	N	Mean	Std. Deviation	N	Mean	Std. Deviation	N	Mean	Std. Deviation
Firm Size	771	568,758	1,271,474	285	820,332	1,786,443	486	477,641	1,009,777
Ownership Concentration	771	54.48	22.07	285	59.64	22.69	486	52.62	21.56

Note: This table presents descriptive statistics (numbers, mean and standard deviation) on Firm Size and capital structure. Firm size is calculated based on the sample firms' total assets and capital structure is measured by ownership concentration calculated as the total percentage of top 5 shareholdings.

Table 4: The timeless of earnings with respect to bad/good news

$$\frac{EPS_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} \times DR_{it} \quad (1)$$

Panel A – Comparison of the results of Equation (1) between pre- and post-adoption

		Full Sample (2000-2009)		Pre-adoption (2000-2006)		Post-adoption (2007-2009)	
Variables	Predicted Sign	Coefficient	t-statistics	Coefficient	t-statistics	Coefficient	t-statistics
C	+	5.57***	4.86	5.61***	4.10	4.27**	1.92
DR	+	5.58***	3.04	3.01	1.28	10.84***	3.17
R	+	0.69	0.30	2.57	0.82	- 0.73	- 0.21
R*DR	+	55.74***	10.33	49.11***	6.67	64.23***	7.70
Adjusted R ²		0.18		0.16		0.21	
F-statistic		58.86***		31.11***		26.18***	
Observations (firm-year)		771		486		285	

Panel B - F – Test

		Sum of Squares	df	Mean Square	F	Sig.
R*DR	Between Groups	1.645	1	1.645	59.107	.000
	Within Groups	21.434	770	0.028		
	Total	23.079	771			

Note: EPS_{it} represents the earnings per share for firm i in fiscal year t; P_{i,t-1} is the price per share of firm i at the beginning of the fiscal year t-1; R_{it} represents the return on firm i from 9 months before fiscal year-end t to 3 months after fiscal year end t; DR_{it} represents a dummy variable set equal to 1 if R_{it} is negative and 0 otherwise.

Note: *, ** and *** represents statistical significance at the 10%, 5% and 1% level respectively.

Table 5: IFRS effect on accounting conservatism

$$\frac{EPS_{it}}{P_{it-1}} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 IFRS_{it} + \alpha_3 DR_{it} \times IFRS_{it} + \beta_0 R_{it} + \beta_1 R_{it} \times DR_{it} + \beta_2 R_{it} \times IFRS_{it} + \beta_3 R_{it} \times DR_{it} \times IFRS_{it} \quad (2)$$

Panel A: All firm-year observations including voluntary adopters

Variables	Predicted Sign	Coefficient	t-statistics
C	+	5.61***	3.81
DR	+	3.01	1.19
IFRS	?	-1.33	-0.54
DR*IFRS	?	7.83**	1.97
R	+	2.57	0.76
R*DR	+	49.11***	6.20
R*IFRS	?	-3.30	-0.71
R*DR*IFRS	+	15.13	1.39
Adjusted R ²		0.19	
F-statistic		26.32***	
Observations (firm-year)	771		

Panel B: Voluntary adopters are excluded (only mandatory adopters)

Variables	Predicted Sign	Coefficient	t-statistics
C	+	6.55***	3.88
DR	+	2.27	0.80
IFRS	?	-2.34	-0.78
DR*IFRS	?	8.70**	1.93
R*IFRS	?	-4.39	-0.71
R	+	-0.04	-0.01
R*DR	+	44.13***	4.87
R*DR*IFRS	+	32.65*	2.62
Adjusted R ²		0.23	
F-statistic		25.24***	
Observations (firm-year)	566		

Panel C: Analysis on voluntary adopters

Variables	Predicted Sign	Coefficient	t-statistics
C	+	3.07	1.10
DR	+	3.48	0.68
IFRS	?	3.29	0.73
DR*IFRS	?	-0.57	-0.06
R	+	9.71	1.46
R*DR	+	57.89***	3.81
R*IFRS	?	-8.45	-1.07
R*DR*IFRS	-	-54.12**	-2.17
Adjusted R ²		0.18	
F-statistic		7.37***	
Observations (firm-year)	205		

Note: EPS_{it} represents the earnings per share for firm i in fiscal year t; P_{i,t-1} is the price per share of firm i at the beginning of the fiscal year t-1; R_{it} represents the return on firm i from 9 months before fiscal year-end t to 3 months after fiscal year end t; DR_{it} represents a dummy variable set equal to 1 if R_{it} is negative and 0 otherwise. IFRS equals 0 for observations acquired before the adoption of IFRS and 1 for observations obtained after the adoption. The variable of IFRS is adjusted based on the actual adopting year (either in 2005 or 2006) for voluntary adopters..

Note: *,** and *** represents statistical significance at the 10%, 5% and 1% level respectively.

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