Incentives for Prior Period Error Corrections under IAS 8

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Introduction

The research problem is to determine whether International Financial Reporting Standard IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* is used to engage in opportunistic reporting practices by Australian companies.

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Prior to the introduction of IAS 8, the Australian standard AASB 1018 *Statement of Financial Performance* required errors to be recognised in the profit and loss of the period in which they were discovered

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IAS 8, and its Australian equivalent, now require prior period errors to be amended retrospectively through an adjustment in the statement of changes in equity.

Introduction

- The mandatory application of IAS 8 for reporting periods beginning on or after July 2007.
- The impact of any prior period errors is shown through retained earnings rather than being included in the current period’s profit or loss.
- Managers could use this treatment for prior period errors as a method for manipulating current period earnings.

Contribution

Ahmed and Goodwin (2007) studied restatements by Australian companies. Relied on reading the notes to the accounts. The mandatory application of IAS 8 for reporting periods beginning on or after July 2007 means that sufficient current data is now available for additional analyses.

Important to understand repercussions for new accounting regulation.

There is a need to identify which accounting standards are being used to manage earnings, so that those standards can be improved (Healy and Wahlen, 1999) .

Useful for standard setters

Overview of Results

More error adjustments when ratio of CEO cash bonus to salary higher.

More error adjustments when poorer than expected financial performance.

More error adjustments when CEO changes.

The results indicate that companies are using IAS 8 as a method of earnings management.

Hypothesis 1

CEO cash bonuses are positively associated with prior period error corrections that adjust prior earnings.

Hypothesis 2 and 3

CEO pay from stock options is positively associated with prior period error corrections that adjust prior earnings.

CEO holdings of stock options are positively associated with prior period error corrections that adjust prior earnings.

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Hypothesis 4

Acquiring new debt and equity finance is positively associated with prior period error corrections that adjust prior earnings.

Hypothesis 5

Poor performance relative to expectations is positively associated with prior period error corrections that adjust prior earnings.

Hypothesis 6

CEO change is positively associated with prior period error corrections that adjust prior earnings.

Research Design - Sample

The sample of error companies collected by financial reports of every company listed on the Australian Securities Exchange Limited in 2008.

2008 was the first period in which it was certain the standard had been fully applied after its introduction.

Used statement of changes in equity

51 companies matched on size and industry.

Measurement of the dependent variables

Earnings Correction collected on Earnings Per Share for all companies in the sample for the disclosure year and the prior year.

EPS figure for the prior year was corrected.

The published EPS for the prior year was then subtracted from the Corrected EPS figure, to give a measure of the impact of the error on EPS.

Measurement of the independent variables

The *Ratio of CEO Bonus Pay to Salary* = cash bonus amount over fees and salary, averaged across the prior year and the year of disclosure.

Value of CEO Options Issued Pay = natural log of declared value (in the published remuneration report) of any options issued to the CEO as incentive pay during the prior year and the disclosure year.

Measurement of the independent variables

CEO Options Held = natural log of the average of the number of options held by the CEO at the beginning of the disclosure year and the number of options held by the CEO at the end of the disclosure year.

Measurement of the independent variables

New Debt and Equity Finance Acquired = categorical variable with a value of 1 for companies where there was an overall increase in debt and equity capital from the disclosure year and the year following disclosure, and 0 otherwise.

Measurement of the independent variables

Poor EPS Performance = change in EPS from the prior year to the disclosure year.

The variable CEO Resigned = dichotomous variable with a value of 1 for companies where the CEO resigned between the end of the prior year and the end of the disclosure year, and 0 otherwise.

REGRESSION MODELS 1 and 2

- Earnings Correction = b_0 + b_1Ratio of CEO Bonus Pay to Salary + b_2Value of CEO Options Issued as Incentive Pay + b_3CEO Options Held + b_4New Debt and Equity Finance + b_5 Poor EPS Performance + b_6 CEO Resigned + b_7Audit Quality + e
- **OLS and Logit regression**

Variables – Descriptive Statistics

Continuous Variables	Minimum	Maximum	Mean	Std. Deviation
Earnings Correction	-3.00	12.00	0.34	1.57
CEO Bonus	0.00	2.07	0.20	0.37
Options Issued	$0	$3,055,000	$208,893	$491,332
CEO Options Held	0	30,000,000	1,777,119	3,509,350
Poor EPS	-549.40	102.40	-7.40	55.80
New Debt/ Equity	82	80.40		
CEO Resigned	17	16.70		
Audit Quality	48	47.10		

OLS REGRESSION

Variables	Hypotheses	*sign*	T	P value
(Constant)			-0.25	0.40
CEO Bonus Pay	H1	+	3.41	**0.00
Value of Options Issued to CEO	H2	+	0.88	0.19
CEO Options Held	H3	+	-1.06	0.15
New Debt Equity	H4	+	0.07	0.47
Poor EPS	H5	+	2.83	**0.00
CEO Resigned	H6	+	2.15	*0.02
Audit Quality		-	0.65	0.26
Adjusted R^2 = 0.21	*F* statistic = 4.73	p < .001		

Conclusion

1. The introduction of IAS8 created a method for managing earnings, countries adopting IFRS.
2. management compensation incentives measured by the ratio of cash bonus to salary and issues of options as incentive pay are positively associated with earnings correction that reduced prior year overstated earnings.
3. Poor performance relative to the prior year is positively associated with prior period error corrections.
4. New CEO’s take a bath to move expenses to prior year.