

ACCOUNTING STANDARDS AND EARNINGS QUALITY

Prof.As.Dr.Ingrid Shuli
i_shuli@yahoo.com**Abstract**

According to the legislation in vigor, the companies with joint capital Albanian and foreign capital such as commercial banks, insurance companies, construction companies, transport companies etc use international accounting standards for financial reporting purpose, meanwhile the Albanian companies use local accounting standards. This paper will explore if the companies that have used international and local accounting standards have a higher earning quality. Based on the existing literature, the companies that use international accounting standards have a lower possibility to decrease the profit, to manage the earning as a tool to avoid the reporting of a loss and have a greater possibility to recognize the loss at the moment it occurs comparing to the companies that do not use the international accounting standards. All the above features are related with the improvement of the earning quality. Comparing the quality of financial reporting before and after the use of the accounting standards, the perception of the Albanian professionals is that the earning quality is increased after the use of accounting standards.

Keywords: Earnings quality, Earnings management, Local accounting standards; IAS, IFRS.

Introduction

In recent years there have been scandals at major corporations, scandals that have been associated mostly with dishonest financial reporting, with the aim to disclose an economic and financial position of the business different from the reality. In such periods, when sensational events occur, it is noticed a greater effort on the part of academics, researchers to find reasons why it happened this or that phenomenon and to suggest solutions. Ronen and Yaari (2007) stress that "the new environment after these scandals raises a number of questions concerning academics, lawmakers and specialists. Earnings management practices, thus the earnings quality can be defined as a strategy to generate accounting profits, which are determined by management decisions on accounting choices and operating cash flows. There are many examples from practice, there are many studies in this field that were encouraged even by these scandals and that showed that the incidence of earnings management are more frequent in companies listed on the stock exchange, so in entities that trade their shares to the public. It is a known fact that the importance of financial information is increased as well as his qualities such as reliability, comparability, etc. In this way, the interested parties for the entity, such as creditors, investors can take the best decisions based on better information. The purpose of setting international accounting standards is exactly to improve the quality of financial statements, since the standardization of items of financial statements may result in more comparable information. Gains are among the accounting items used to assess performance. In this way, if an entity provides qualitative and quantitative indicators to assess the earnings quality of it has provided a good basis for evaluating the financial conditions and its performance.

Literature review

Previous studies have shown that accounting standards can add value to accounting information in economic development (Hung and Subramanyam, 2004). Kolhbeck and Warfield (2005), reviewed some important standards relating to balance sheet assets and liabilities, such as standards for pensions, post retirement benefits, for taxation and financial instruments, to conclude on the quality of accounting indicators for the period 1980 - 2002.

They found evidence that use of these standards leads to high levels of quality of accounting information, but also in the lowest forecast errors. But when the quality of forecasting errors decrease, increases the ability of users of accounting information. In this way accounting standards increase the predictability of accounting information. Some other researches like Hodge (2003) argue that earnings quality is the degree of continuity of current earnings in the future. Thornton et al. (1987) asserts that the term "earnings quality" was one of the keys to a proper financial analysis. According to Penman (2002), the quality of accounting should be discussed in accordance with the interests of shareholders and fair assessment of these interests. Revsine et al. (1999) claim that profits have the highest quality when they are stable. While Penman and Zhang (2002), define that sustainable profits and high quality earnings, are a good indicator of future earnings. While White et al. (2003), assert that the earnings quality is related to the degree of conservatism in reported earnings of the company. Previous studies on the quality of accounting standards give us different results. Thus, Barth et al. (2005) and Bartov et al. (2004), concluded that the adoption of IAS - s enhances the quality of accounting. Based on a large number of companies taken as an example, companies operating in different countries of the world, Barth et al. (2005), claim that after the implementation of the standards, companies evidence less earnings management than companies that do not use the international accounting standards¹. While Bartov et al. (2004), claim that for a group of German companies taken as a sample, the value of accounting profits calculated based on international accounting standards is more important than for those companies that use local accounting standards Kolhbeck and Warfield (2005), used four indicators of accounting quality as a representative, to analyze the effects of accounting standards in the U.S.: forecasting the errors, the sustainability of profit, the earnings response coefficient², and the quality of increasing items. They found that there is no major

¹ Profit Management is a strategy used by management to manipulate the company profits so that the figures can be comparable with the objectives predetermined from the management.

² ERC Earnings Response Coefficient. Represents the ability of earnings to describe changes in the return on shares.

changes to the sustainability of profit before and after the requirements of standards, but it is reduced the ability of forecasting errors by analysts after the settlement and after the new standards requirements. While Morais and Curto (2007) use these indicators to measure the quality of earnings: the variability of the net profit ratio to total assets, the ratio of net profit variability with the variability of cash flows from operating activities, the correlation between increasing items of profit and cash flows etc. They claim that the entities report less profit under the standards comparing when they reported to local accounting standards.

Methodology

The methodology used in this study is the survey. This approach made it possible to describe and compare some characteristics of the selected population, but also to prove that such features exist and can be extended to a much larger population. To realize the surveys have been included certain categories of population: Albanian accountants working in commercial banks, accountants working in insurance companies, accountants working in large manufacturing companies. Regarding the type of survey conducted, the most appropriate for the conditions of our country, where we encountered difficulties in providing financial information, were used interviews as a more personal and more appropriate than the research questionnaires. This study contributes to the literature in several directions. First, the empirical evidence provided in this paper suggests that the use of accounting improves financial reporting standards, the regulatory bodies can promote the proposal for approval and implementation by the entities. This conclusion is important especially now that the local standards have begun to be implemented. Second, the findings of this study may help investors understand the earnings quality issues in Albania.

The situation in Albania

Based on studies conducted in the country, Bollano (2008) claims that since January 1, 2008, in Albania are used accounting standards for the preparation of financial statements. While in a report to UNDP Albania, (2008) was stated that the adoption of IAS - s in Albania will increase the transparency, comparability of reporting and accountability with respect to accounting and finance. These standards will improve the quality of comparability in relation to financial information reported by public and private sector in Albania. In this paper we will focus on the characteristics of Albania, considering it as a special case study, based on an empirical research. I would like to point out that countries like Albania have the advantage of all this information on financial sensational events in the world, information that should be used in order to not commit the same errors as has happened in developed countries, to throw positive steps forward both in terms of new legislation which should comply with that of developed countries and in terms of implementing this legislation. In these new conditions, the positive effects will be significant. This is the aim of paper, so the positive effects of the international financial reporting standards (IFRS) or international accounting standards on the quality of financial reporting and earning quality. In the process of its

transformation from centralized to market economy, Albania has realized the importance of stable financial infrastructure. The aim of previous accounting system and legislation was to provide information to different levels of government, for planning control purposes. Consequently, the reported financial indicators of performance were not appropriate for the financial reporting objectives in a market-oriented economies. During the progress towards a market economy in Albania were developed the financial institutions, trade relations with foreign market, the financial market. This period was characterized by sustained economic growth, which required new objectives of financial reporting. All entities in the country, operate as profit businesses, so their managers, but even all users need important financial information to make decisions, to ensure efficient allocation of capital. At the same time, in Albania were established joint ventures with foreign companies, enabling the introduction of advanced technologies and the movement of capital between the countries. These newly created circumstances have made necessary the adoption of accounting standards to meet the requirements of investors, creditors, management and government, making the necessary reforms in the accounting field over the past two decades. According to Bollano (2008) accounting is a language and globalization of financial activities, increasingly requires a common language. This can be accomplished through the system of Standards. Standards will unify accounting practices, will flat out the boundaries between nations and will direct attention to national and international markets. If markets function properly and capital will be allocated efficiently, investors will demand transparency and will reflect accurately the performance of the economy, investors will be able to compare different companies for rational investment, particularly in a rapidly globalized world. The need for Accounting Standards converging appear even more powerful when even large corporations go to bankruptcy or financial crisis that has emerged today. Bankruptcies underline the critical importance of corporate governance, placing them under the limited responsibility such as the responsibility of the board of directors, the independence of auditors, and the quality of opinion and not less important is the quality of accounting standards. Ministry of Finance on the proposal of the National Accounting Council, announced to implement the Fifteen National Accounting Standard, thus starting the most important reform in setting accounting standards. These standards represent important steps to bring the Albanian accounting system in line with international practices. Through the implementation of these standards is required to improve the accounting of entities form point of qualitative and quantitative view. Joint companies in Albania, with Albanian and foreign capital, such as commercial banks, insurance companies, construction companies, transport companies etc., use international accounting standards for financial reporting purpose, while Albanian companies use local accounting standards. According to the National Accounting Council, as the most important body for proposing accounting standards, we have 15 national standards, which are based on

international accounting standards. Below we will provide a summary of these standards, giving even their impact on earnings quality.

No. NAS	National Accounting Standards	The impact on earnings quality
1	General principles for the preparation of financial statements	This standard improves the earnings quality, because it encompasses the concepts of conservatism, neutrality, completeness and providing timely information.
2	Preparation of Financial Statement	This standard improves the earnings quality, because it encompasses the concepts of conservatism, neutrality, completeness and providing timely information.
3	Financial Instruments	This standard deals with the valuation of these assets and liabilities, which are defined as financial instruments. The standard also requires that all changes in the carrying value of financial instruments will be recognized in the income statement.
4	Inventories and biological assets	This standard presents the effects of inventory impairment in the value of net profit
5	Tangible assets and intangible assets	Illustrates the concept of depreciation and revaluation, and therefore affects the net profit
6	Provisions, contingent liabilities and contingent assets	Refers to the quality of accounting, because provisions incur costs at the end of accounting period
7	Leases	This standard requires the recognition of revenues and expenditures for different types of lease.
8	Revenue	Standard main subject is the recognition of revenues
9	Business combinations	This standard requires amortization of goodwill.
10	Accounting for Government Grants and other government assistance	Reflects the process of recognition of income received from government or government agency based on the terms and conditions required by the government
11	Tax on profit	This accounting standard deals only with the tax liability (asset) arises from comparison of tax liability and the amount actually paid, as well as income and expenses related to its.
12	The effects of changes in Foreign exchange rates	Since this standard shows the effects of exchange rates in international transactions and how to account for income / expenses from exchange rate fluctuations, it affects the net profit
13	Biological assets	This standard presents the effects of biological assets impairment in the net profits
14	Accounting of related party and associates	This standard applies to the subsequent evaluation in the Financial Statements of the investment in relate parties and associates after their purchase.
15	Accounting of micro entities	This standard sets rules for implementing the principles for the disclosure of economic events in the Financial Statements of micro entities. These entities are allowed to keep the accounting on accrual basis and cash basis.

We can see from the summary table of standards, that most of them affect the quality of earnings, because of their impact on the process of recognition of revenue. Different researchers have reached the above conclusion by performing empirical studies through the use of regression analysis, as Kolhbeck and Warfield (2005). In this study is used the survey method to reach the same conclusion on the impact of standards on the earnings quality. From interviews with accounting experts of different economic units such as banks, insurance companies and manufacturing entity have received sufficient information to draw conclusions on the extent of use of national accounting standards in Albania (from 1 January 2008) and their impact in the quality of financial reporting and consequently on the earnings quality. Thus, all respondents who work in the above sectors responded that have implemented the international and national accounting standards and prepare

the financial statements based on their requirements. As for the difficulties in their work during the implementation of IAS / NAS – and the type of difficulties: related to the evaluation of financial statement items, related to the application of accounting methods or related to the adaptation with the new way of disclosure of the items in the financial statements, generally have responded that they encountered difficulties related to the new way of disclosure of the items in the financial statements. Interviews show that difficulties are encountered due to lack of information on IAS / NAS - to, the training needs of staff who would work directly with the evaluation of items of financial statements and preparing the financial statements. The opinion of professional accountant's on the impact of IAS / NAS - in the quality of financial reporting of profit is positive, so they consider important the impact of accounting standards in indicators such as profit and equity. The opinion of the

specialists who participated in this survey conforms to the suggestions of the National Accounting Council for this stage of accounting standards implementation. So, full implementation and correctly of Accounting Standards NAS-s and IAS-s) requires an ongoing commitment not only of the entity that will implement them, but also to professional bodies, supervisory bodies and other government bodies. Problems encountered at this stage from entities obliged to apply IAS / NAS are the organizational and technical. Each entity in turn has highlighted the problems that have emerged, presented them and sought solutions. For some of issues they have taken an response, meanwhile for some other issues they had no answer, maybe because they had not addressed the problems to the proper organization. Implementation of Standards with quality has a very great public interest, either nationally or internationally. In particular they are significant in the accounting practices and entity governance.

Conclusions

Albanian entities which are required to adopt international accounting standards (IAS) and International Financial Reporting Standards (IFRS), such as commercial banks, insurance companies, branches of foreign companies, have worked and are working in compliance with these standards earlier than required by the respective legislation, so before 1 January 2008. There remains a small number of entities

that will implement the IAS(IFRS) by law and do not have the necessary experience and will have to make efforts for the recognition and implementation of IAS. Full implementation and correctly of Accounting Standards (NAS and IAS) requires an ongoing commitment not only of the entity that will implement them, but of professional bodies, supervisory bodies and other government bodies. From the study of existing literature in the area of financial reporting and the earnings quality results that the adaptation of the use of IAS is associated with higher quality earnings. This affects the transparency and decision making by the management of entities, but also public confidence in financial reporting of those entities. This conclusion came from comparing the data of profit to various economic entity before and after the implementation of international accounting standards. From these studies conducted in different countries of Europe and beyond, it turns out that after starting to use IAS, IFRS economic entities that are required by law to prepare financial statements according to the standards, report less smoothing of earnings, which is closely related to improving the earnings quality.

Due to lack of stock exchange in Albania, (we do not know yet for how long will it take absence), we find it difficult to extend the study of the impact of IAS on the earnings quality of listed companies.

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