Do accounting standards matter?

A study about how enforcement can affect accounting

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Preface

This Master Thesis was conducted during the spring of 2012 within the Master programme of Business Administration/Financial Accounting at the University of Gothenburg School of Business, Economics and Law in Sweden.

We want to thank our tutors Jan Marton and Emmeli Runesson for the help and guidance that we received during the time of the thesis. We also want to give a special thanks to Emmeli Runesson for the support with the statistical testing. Finally, we want to thank the opponent groups for their thoughts and opinions.

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Abstract

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Background and Problem discussion: In 2005 it became mandatory for all companies listed on stock exchanges within the EU to follow IFRS in their consolidated financial statements. This study examines whether companies better adopt the same accounting rules when it is presented in another context, i.e. when the standard is emitted by the IASB and enforced by the EU instead of the previous Swedish standard setting body. According to previous research mandatory adoption of IFRS has decreased earnings management level for French companies.

Purpose: Our aim is to see if Swedish companies have changed their reporting of provisions after the mandatory adoption of IFRS in 2005, even though the content of the standard has not been changed. We want to establish whether mandatory adoption of IFRS contribute to a reduction of big bath accounting in terms of larger negative provisions in the year of an Executive change, negative results or extra large gains.

Methodology: The thesis is based on a quantitative study and includes 223 companies. The data is collected from annual reports and the years tested are 2002-2010.

Analysis and conclusion: Our result presents the existence of big bath accounting regarding provisions in Swedish companies. The study concludes that the mandatory adoption of IFRS by Swedish companies in 2005 contributes to the reduction of big bath accounting when it comes to larger negative provisions in the year of a CEO change, a negative result and an extra large gain. An important aspect is the fact that the content of the standard for provisions has not been changed during 2002-2010. However, the application of the standard has changed. One main reason might be that the accounting procedures came into greater focus when the EU decided to implement IFRS. Another reason might be the enforcement factor, both in regards to stronger legal enforcement in 2005 and the awareness of an evolving enforcement organization within the EU. According to our study, the big bath phenomenon has decreased in Sweden after the mandatory adoption of IFRS, which implies higher accounting quality.

Keywords: Big bath accounting, earnings management, provisions, IFRS, enforcement, accounting resources and CEO changes.

Abbreviations

CEO   Chief Executive officer

CESR   The Committee of European Securities Regulators

EECS   European Enforcers Co-ordination Sessions

ESMA   European Securities and Markets Authority

EU   European union

GICS   Global Industry Classification Standard

IAS   International Accounting Standards issued by the IASB

IASB   International Accounting Standards Board

IFRS   International Financial Reporting Standards

RR   Redovisningsrådets rekommendationer

SPMFR   the Swedish Panel for Monitoring Financial Reporting

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1. Introduction

This chapter starts with a historical background about IFRS in Europe and a short introduction to the phenomenon big bath accounting. This is followed by a discussion regarding the problem and previous research made in the field that results in the formulation of the research questions and the purpose of this thesis. Finally, a presentation of the study's contribution, delimitation and keywords.

1.1 Background

One of the aims for the European Union is to have an open capital market and lower barriers to entry. This leads to an increased mobility of capital for countries within the European Union, furthermore this builds up an integrated market of financial services and constructs protection for investors. The International Accounting Standards Board (IASB) was started in 1973 as the International Accounting Standards Committee (IASC) and has the intention to increase the comparability among annual reports by standardizing and harmonizing accounting practices. (Lundh 2009)

In 2005 it became mandatory for all companies listed on stock exchanges within the EU to follow IFRS in their consolidated financial statements. Before 2005 the Swedish listed companies followed *Redovisningsrådets rekommendationer* (RR) in their consolidated financial statements. RR is since 2000 based on IAS and from 2005 no longer updated. (Lundh 2009) RR 16 was issued in 2000, mandatory from January 1st 2002 and corresponded completely to IAS 37 (RR16).

According to Zéghal *et al.,* (2011), mandatory adoption of IFRS has decreased earnings management level for companies in France with good corporate governance and those that depend on foreign financial markets. A term associated with earnings management is big bath accounting. The phenomenon arises when managers want to make a poor result look even worse in order to save income for future years. An illustration for big bath accounting could be cases when a manager writes of a lot of expenses to blame the manager he had replaced for poor results. This results in a higher future income, which can lead to future bonuses. (Penman 2003)

In a recent study, Geiger & North (2011), have summarized prior research that confirms the phenomenon big bath accounting. The earlier studies have consistently found that companies appointing new Chief Executive Officers (CEO) are more likely to report reduced income in the initial year of the new CEO, and then report increased income in the immediately succeeding years.

According to an analysis from the research company Chevreux, Ericsson manipulated their earnings in 2003 when Carl Henrik Svanberg became the CEO of the company. That year, the firm made a record figure provision of SEK 28,7 billions, whereof SEK 13,5 billion was in

the category of *other provisions*. According to the company, those *other provisions* was mainly an effect of legal disputes, but according to Chevreux the results of the following years were manipulated by the returning provisions of a total amount of SEK 11,8 billion. (SvD 2007)

1.2 Problem discussion

One of the areas often discussed in connection with earnings management and big bath accounting is provisions. Over-generous provisions are a classic creative accounting device for smoothing earnings, by depressing profits in good years and bumping up bottom lines when times are bad (Accounting 1998). One of the objectives of IAS 37 was to reduce firms' discretion in reporting provisions. The IASB chairman Sir David Tweedie once said that a main focus of IAS 37 is *big bath provisions*. According to Tweedie the provisions are all too often wildly excessive and conveniently find its way back to the income statement in a later period. (Elliott&Elliott2006)

Companies are more likely to take big baths when new managers take over, but also when a company has a large non-recurring gain or when earnings are particularly weak (Riahi-Belkaoui 2003). We want to examine if mandatory adoption of IFRS has decreased the phenomenon of big bath accounting when it comes to larger negative provisions in the year of an executive change. We will also study if the phenomenon has decreased when it comes to larger negative provisions in the year of a negative result or an extra large gain. The content of the standard regarding provisions (IAS 37) will not be the issue in this study since the earlier standard, RR 16 was based on IAS 37 and had the same content for the Swedish companies. (RR 16) We want to examine if companies better adopt the same accounting rules when it is presented in another context, i.e. when the standard is emitted by the IASB and enforced by the EU instead of RR.

Accounting rules can limit a manager's ability to manipulate reported earnings. But the extent to which accounting rules prevent earnings management depends on how well these rules are enforced. (Leuz *et al.,* 2003) According to Jeanjean & Stolowy (2008) countries institutional structures play an important role in explaining accounting quality after the mandatory adoption of IFRS. Some evidence shows that strict enforcement regimes and institutional factors provide strong incentives for high-quality financial reports after the introduction of IFRS reporting. (Jeanjean & Stolowy, 2008) Böcking *et al.,* (2011) also make a contribution to the notion that enforcement of accounting standards is of utmost importance in order to achieve high quality accounting.

According to Bichut (2005), the year 2005 was a major milestone for IFRS as many companies around the world begun to use this new financial language for their external reporting. The conversion into IFRS is a far-reaching effort that affects numerous areas throughout the enterprise: from corporate business functions such as tax, accounting and finance; organizational structures; legal contracts; corporate and business unit responsibilities;

executive compensation; and internal audit (Singer 2009). A training program for staff across a company is needed to let them adopt an entirely different system of business operations, performance measurement, and communication with the markets. The average total cost for IFRS conversion is put at euro 8.7 million (Bolton 2005).

Since the implementation of IFRS forced companies to review their accounting procedures, educate their staff, and start a great reorganization it can be assumed that the general accounting quality has improved among listed companies after the implementation of IFRS. Accounting quality can be defined as accounting that is useful for the investors' decision making (Marton 2009). Manipulated results is not useful for investors decision making, therefore the lack of manipulation enhances accounting quality. With this in mind we want to examine whether the mandatory adoption of IFRS in 2005 has reduced the presence of big bath accounting in Sweden.

1.3 Research questions

1. *Did big bath accounting exist in Swedish companies during 2002-2010?*

2. *Did the mandatory adoption of IFRS by Swedish companies in 2005 contribute to a reduction of big bath accounting?*

1.4 Purpose

Our aim is to see if Swedish companies have changed their reporting of provisions after the mandatory adoption of IFRS in 2005, even though the content of the standard has not been changed. We want to establish whether mandatory adoption of IFRS contributes to a reduction of big bath accounting in terms of larger negative provisions in the year of an executive change, negative results or extra large gains.

1.5 Contribution

Previous research (Healy 1985; Murphy & Zimmerman 1993; Geiger & North 2011;) have come to the conclusion that big bath accounting is an existing phenomenon. In this thesis our focus is; if the phenomenon big bath accounting regarding provisions has decreased since IFRS was adopted in Sweden in 2005. Jeanjean & Stolowy did a similar study in 2008. They examined whether the mandatory adoption of IFRS had decreased the level of earnings management for companies in Australia, France and the United Kingdom. In 2011 Zéghal *et al.,* also studied this phenomenon after the introduction of IFRS in France.

Compared to these earlier studies, our study is more specialized since we concentrate on the phenomenon big bath accounting and we only consider provisions. Since the content of RR 16 is identical to IAS 37, the standard is constant during the years examined in our study. However, the enforcement of the standards have changed and is therefore a possible reason

for any change regarding the use of provisions when it comes to big bath accounting. The fact that the standard is constant in our study differs our study from the others mentioned.

1.6 Delimitation

Regarding big bath accounting, we will concentrate on provisions and no other items such as impairment or depreciation of assets. When referring to IAS 37, we will exclude Contingent Liabilities and Contingent Assets from our study. Provisions for pensions are not included in IAS 37 and therefore excluded from our study. Delimitation is made to only include companies listed on Nasdaq OMX Nordic Stockholm during the years 2001 – 2010.

1.7 Outline

Introduction

- This chapter consist of the background, problem discussion, research question, purpose of the thesis and contribution. Finally, the delimitation and the keywords.

Frame of reference and hypothesis development

- This second chapter presents the theory in the field and the hypothesis of the study.

Methodology

- This chapter describe the method and the research design of the survey followed by the sample, collected data and control variables. Finally, a presentation of the statistic model.

Empirical results

- In chapter five we present the empirical results.

Analysis

- In this sixth chapter the frame of references and the empirical results are analyzed in relation to the hypothesis.

Conslusion

- In the final chapter, we present the conclusion. This chapter also contains suggestions for further research.

2. Frame of reference and hypothesis development

This chapter presents the theoretical background followed by our stated hypotheses. First a description of enforcement in Sweden and by the EU, then accounting resources and finally earnings management and big bath accounting. The intention is to use the theory as an analytical tool for interpreting the hypothesis development.

2.1 IFRS enforcement

Ball *et al.,* (2003) argue that there is a strong focus in the accounting literature on accounting standards and how they vary across countries. They suggest that political forces, such as government enforcing accounting standards, are important variables that affect financial reporting practice. Lundh (2009), states that without adequate enforcement, the accounting regulations are simply requirements on paper.

2.1.1 Enforcement in Sweden

In 1989, the Swedish Financial Accounting Standards Council (*Redovisningsrådet)* was jointly founded by the accounting profession, the government, and the preparers and became a new standard setting body for public companies. In the years to come, *Redovisningsrådet* started adopting all IAS and IFRS. During 1991 to 2004, it issued 34 recommendations. (Hellman 2011a) RR 16 was issued in 2000, mandatory from January 1st 2002 and corresponded completely to IAS 37 (RR16).

Hellman (2011b) states that, the mandatory adoption of IFRS in 2005 should not have had any effect on accounting, since the recommendations from *redovisningsrådet* were based on the equivalent IAS standards. However, there was a difference in the level of legal enforcement, which could affect accounting quality. Before 2005 Swedish companies could either comply with the recommendations from *redovisningsrådet* or explain deviations from them according to their listing contracts with the Nasdaq OMX Nordic Stockholm. In contrast; the regulation (EC) No *1606/2002* constitutes as legislation from 2005. According to Hellman (2011b), the Swedish listed companies might have perceived the room for application of different IAS standards as larger, when they were recommendations from *redovisningsrådet* compared to when they are part of the EU-legislation. The enforcement institutions in Sweden were considered as weak during 1991-2004 and for many years, compliance with the RR recommendations was monitored primarily by auditors. Hellman (2011b) This period is considered as a soft adoption of IFRS. (Hellman 2011a).

In response to demands from the EU to improve the enforcement, the Swedish Panel for Monitoring Financial Reporting (SPMFR) (*Panelen för Övervakning av Finansiell*

Rapportering) was founded in April 2003 (Hellman 2011a). Their mission was to monitor that Swedish companies listed on a Swedish stock exchange or authorized marketplace, establish financial reports according to law or other constitution. The purpose was to protect the investors and maintain the public's confidence for the capital market. To ensure this, they reviewed financial reports after they had been published and submitted their decisions to the stock market where the company was listed or had stocks registered. (Övervakningspanelen 2006). However, Hellman (2011a) refers to a report by Grundvall *et al.,* (2004) covering annual reports for 2003, which states that the firms had adopted a view that they could make certain deviations from RR without clearly describing it in their annual reports. Hellman also refers to an examination of the annual reports for 2004 by SPMFR, which showed several cases of noncompliance in Sweden. (Hellman 2011a) During 2006 it was decided that the SPMFR should be put down and cease to review annual reports in 2007 (Övervakningspanelen 2006).

Since 2007, there are three enforcers in Sweden; *Swedish Financial Supervisory Authority* (Finansinspektionen), *The Nordic Growth Market* and *Nasdaq OMX Stockholm.* (ESMA 2011). The supervision is made by the stock exchanges, and the *Swedish Financial Supervisory Authority* has the overall responsibility that the stock exchanges are doing their job (Financial reporting.se, 2012).

2.1.2 Enforcement by the EU

ESMA (European Securities and Markets Authority) is an independent EU Authority that contributes to safeguarding the stability of the EU's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. ESMA has replaced the Committee of European Securities Regulators (CESR) in 2011 and have new competencies and powers. (ESMA 2012)

The CESR's definition of enforcement is:

> *Monitoring compliance of the financial information with the applicable reporting framework and taking appropriate measures in case of infringements discovered in the course of enforcement.* (CESR 2003)

ESMA provides reports on the monitoring compliance of financial information with IFRS and the taking of appropriate enforcement actions in the European Economic Area (EEA). These reports are based on the activities of the European Enforcers Co-ordination Sessions (EECS), which operate under the oversight of ESMA. The main objective of the EECS is to coordinate the enforcement activities of Member States in order to increase convergence amongst European enforcer's activities, which should contribute to fostering investor's confidence. (ESMA 2011)

The need for an effective enforcement infrastructure is recognized as important in the European Commission's Strategy document of 2000, which states that enforcement necessitates clear accounting standards, timely interpretations and implementation, guidance, statutory audit, monitoring by supervisors and effective sanctions. With regards to the supervisory role and effective sanctions, the European Commission's approach has constantly been to delegate the enforcement process to domestic securities market regulators. (Pope & McLeay 2011). *Appendix 1.1* shows the European implementation framework.

The legal responsibility for enforcement rests with National Regulators working within the framework established by CESR. The framework by CESR is founded on two Standards defining the criteria thought necessary to ensure effective enforcement of compliance with IFRS. (Pope & McLeay 2011). CESR aimed at providing for a sufficiently complete set of enforcement standards by 2005. (CESR 2003) This was managed since Standard No. 1 was issued in 2003 (CESR 2003) and Standard No. 2 was issued in 2004. (CESR 2004)

CESR's Standard No. 1 on Financial Information: Enforcement of Standards on Financial Information in Europe' establishes the minimum criteria that each member state should satisfy in order to meet the obligation to ensure effective enforcement mechanisms. For example, enforcement reviews should be carried out by independent and competent authorities or other bodies, and should be based on cases selected by a combination of risk-based assessment and a rotation or sampling approach. When material non-compliance or misstatements are uncovered, enforcers are required to take appropriate actions in a timely and consistent fashion. (Pope & McLeay 2011)

The other standard; CESR's Standard no. 2 on Financial Information – Coordination of Enforcement, exposes CESR's proposals for achieving the necessary coordination and convergence of enforcement activities carried out by EU National Enforcers. (CESR 2004) The standards created by the CESR were seen as further steps after the decision of mandatory adoption of IFRS, taken by the EU for further harmonization between the countries regarding financial reporting (CESR 2003). In order to avoid the creation of national approaches to IFRS, Standard no.1 recognizes the need to promote harmonization. This implies that enforcers should try to take their decisions in the most consistent way: the aim being that similar decisions are taken where similar circumstances take place all over Europe. (CESR 2004) It was not until 2007 that Sweden started enforcement activities in fully accordance with CESR Standard No.1 (CESR 2007).

2.2 Accounting resources

According to Bichut (2005), the year 2005 was a major milestone for IFRS as many companies around the world begun to use this new financial language for their external reporting. On 19 July 2002, the European Parliament issued a regulation (1606/2002/EC) requiring all EU listed companies to prepare consolidated financial statements based on International Accounting Standards (IAS/IFRS) by 2005 (Zéghal *et al.*, 2011). Jermakowicz

& Gornik-Tomaszewski (2006) refer in their study to Eichhorst *et al.*, (2002) who claim that the consequences of implementing IFRS will undoubtedly go far beyond a simple change of accounting rules by the companies concerned. The process of implementing IFRS is costly, complex and burdensome.

There is a general consensus that one of the most important challenges in implementing IFRS is the complex nature of the standards. This complexity has contributed to the costs and efforts involved in financial reporting which often fall disproportionately on smaller public and private companies. (Jermakowicz & Gornik-Tomaszewski, 2006)The conversion into IFRS is a far-reaching effort that affects numerous areas throughout the enterprise: from corporate business functions such as tax, accounting and finance; organizational structures; legal contracts; corporate and business unit responsibilities; executive compensation; and internal audit (Singer 2009).

The average total cost for IFRS conversion is put at euro 8.7 million (Bolton 2005). According to Jermakowicz & Gornik-Tomaszewski (2006), who refer to a study by Hoogendoorn (2006), a training program for staff across a company is needed to let them adopt an entirely different system of business operations, performance measurement, and communication with the markets. This training will be an ongoing exercise since IFRS is a moving target. Audit firms play the crucial role in this training program. The involvement of auditors is so significant that they run the risk of becoming heavily involved in preparing the financial statements they are required to audit. This is mainly caused by the complexities of IFRS where many entities, especially smaller listed entities, lack sufficient expertise. (Jermakowicz & Gornik-Tomaszewski 2006)

Since the implementation of IFRS forced companies to review their accounting procedures, educate their staff and get into a great reorganization it can be assumed that the general accounting quality has improved among listed companies after the implementation of IFRS. Accounting quality can be defined as accounting that is useful for the investors' decision making (Marton 2009).

2.3 Big bath accounting and hypotheses

Healy & Wahlen (1999) describe earnings management as:

> *Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.*
> (Healy & Wahlen, 1999, p. 368)

Riahi-Belkaoui refers to an article by Copeland & Moore (1972) when describing big bath accounting as an earnings management technique that can be described as inflating future

income by depressing current income. Assets are written down or written off and provisions are made for estimated losses and expenses, which may be incurred in the future. Riahi-Belkaoui refers to Schilit (1993) when explaining that companies are more likely to perform big bath accounting in three particular situations. First, when new managers take over, they are tempted to write off the old projects and assets of their predecessors to show strong improvements the coming years. Second when a company has a large non-recurring gain, it might search for expenses to charge against it. And third, when earnings are particularly weak, management sees an opportunity to add additional expenses, which will most likely not even be noticed, to the current period. (Riahi-Belkaoui 2003)

If earnings are so low that no matter which accounting procedures are selected, target earnings will not be met, managers have incentives to further reduce current earnings, to be ensured that they could report increased income in the future (Healy 1985). Stalebrink (2007) found evidence that Swedish municipalities increase the size of discretionary accruals during a year of a negative result.

Murphy & Zimmerman (1993) found evidence for the existence of big bath accounting regarding CEO changes. In a more recent study by Geiger & North (2011), the authors summarized prior research that confirms the phenomenon big bath accounting regarding CEO changes. The earlier studies have consistently found that companies appointing a new CEO are more likely to report reduced income in the initial year of the new CEO, and then report increased income in the immediately succeeding years. In their study, Geiger & North (2011) also confirmed prior studies when they found that the change in total discretionary accruals is negative and significant in the first reporting year when a firm appoints a new CEO. According to Schilit (2002) big bath accounting could be seen as a guarantee for the CEO that the performance improves the next year. Another incentive to reduce income could be when a company already has met the financial target; they may attempt to shift the next year's expenses into this current year. Hence for preparing expenses to boost the next year's profit (Schilit 2002).

When managers want to reduce a large non-recurring gain it is also called *income smoothing*. Fudenberg & Tirole (1995) characterize income smoothing as a process of manipulating the time profile of earnings to make the reported income less variable. An essential characteristic for income smoothing that is different from other similar processes of trying to exaggerate earnings, is when managers' are taking actions to increase gain when it is relatively low, and to decrease gain when gain are relatively high.

Considering the fact that big bath accounting occurs in three different situations, it leads us to the following hypothesis:

H1
Big bath accounting exists in Swedish companies

Jeanjean & Stolowy (2008), claim that earnings management was not reduced after the mandatory adoption of IFRS in 2005, in either Australia, France or United Kingdom. They analyzed the distribution of earnings to discover whether companies have managed their earnings to avoid losses any less after the implementation of IFRS in 2005 than before the implementation. Irregularities in distributions were perceived as an indication of earnings management. In opposite to Jeanjean & Stolowy (2008), Zéghal *et al.,* (2011) claim that the mandatory adoption of IFRS has decreased earnings management level for companies in France with good corporate governance and those that depend on foreign financial markets. In their study, they found that the use of discretionary accruals was reduced after the IFRS adoption. Discretionary accruals was calculated as the difference between total accruals and estimated non-discretionary accruals. Although Zéghal *et al.,* (2011) found evidence that earnings management had decreased after the adoption of IFRS, the authors suggested that a stronger enforcement mechanism for the implementation of IFRS must be instituted to ensure its positive impact on the quality of accounting information.

In accordance to the study by Zéghal *et al.,* (2011), we suggest that big bath accounting regarding provisions will decrease after the mandatory IFRS adoption in Sweden. A possible reason for a decreased level of earnings management after the adoption of IFRS is that there has been a stronger level of legal enforcement in 2005 for Swedish listed companies. The fact that companies during 2005 have invested more resources in accounting can also lead to a higher accounting quality. From this we have the following hypothesis:

H2
Mandatory adoption of IFRS by Swedish companies contributes to the reduction of big bath accounting

3. Methodology

In this chapter the method of the study will be present, a description of the research design of the survey followed by the collected data and sample. The chapter ends with a presentation of the model used in the study.

3.1 Research design

In our study we want to examine whether the mandatory adoption of IFRS has contributed to the reduction of big bath accounting when it comes to larger negative provisions in the year of an executive change, or in the year of a negative result, or an extra large gain. The model below is visualizing how we will perform our quantitative research. We want to test if the phenomenon of big bath accounting existed in Sweden during 2002-2010 and if the phenomenon was more present before the mandatory implementation of IFRS in 2005 than after. We have decided to examine the years 2002-2010 since RR 16 was mandatory from January 1st 2002 and since then corresponded completely to IAS 37 (RR 16). *Appendix 1.2* shows a comparison between the two standards.

The test will be conducted by using three regression models, one for each area, i. e. CEO changes, negative result and extra large gains. The regression models will show how our dependent variable, Δ *provisions* is affected by the main independent variables *CEO changes, negative result and extra large gains*. We will multiply a variable for IFRS adoption with each of our main independent variables; C*EO changes, negative result* and *extra large gains* in each regression model to establish whether the phenomenon of big bath accounting has decreased after the mandatory IFRS adoption. We will also use control variables in our regression models to make sure that the study is not biased. All variables included in the regression models will be summarized in *Table 1* in the empirical chapter.

Visualization of the H1 hypotheses
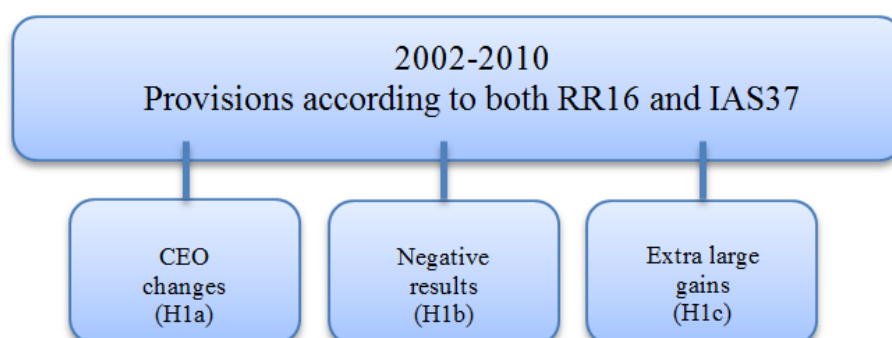
Visualization of the H2 hypotheses
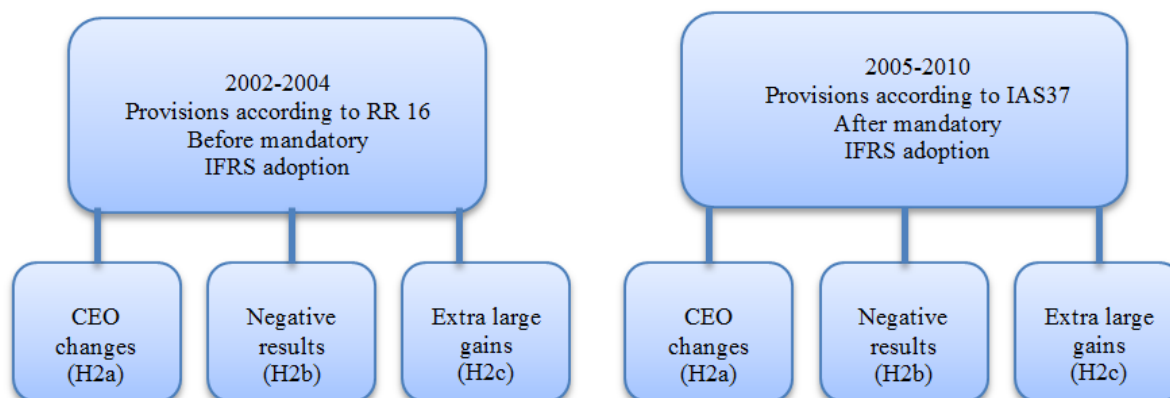
3.2 Data collection

The data is collected from annual reports from the years 2001-2010, and also "dead" companies non existing today are included. Data from 2001 is included since we had to establish the change of total provisions, i.e. Δ provisions for 2002. The database used for providing data is Thomson Reuters Datastream and the data collected were *Provisions for risks & charges*, *Pension / post retirement benefit*, *Total assets*, *Common Shareholders' equity*, *Net income*, *Total Debt*, and *Stock exchange*. The variables in our regression models are built on this data. Information that supports the hypotheses are collected from secondary sources, such as journal articles, theses and books.

The data collected from Datastream were not always complete. Some companies were stated as *ERROR* for all years examined and they are therefore excluded from the study. Since the remaining companies were still a large enough sample for the statistical testing it was not necessary to collect the missing data manually. Observations were missing for some years for some companies. A possible explanation to this is that these companies were not listed during these years. All observations we received are included in our study, also companies with missing values for some of the years. Random sampling has been made from the collected data in order to increase the reliability of the study (Jacobsen, D. 2002). We selected 20 companies randomly that we manually compared to annual reports.

3.3 Sample

The sample of 1253 companies is collected from the database Thomson Reuters Datastream. The companies selected for the research are all listed at the Small- Mid and Large Cap on the Nasdaq OMX Nordic Stockholm. Preferably, the sample of companies should be large and representative, since the sample will be divided into subgroups and it is important to meet the minimum sample size requirements (Blumberg *et al.,* 2008). However, only listed companies are selected since they have more information available, they are being more reviewed by

external stakeholders and shareholders and also they have more incentives to generate high quality accounting information**.**

The final sample consists of 223 companies in ten different sectors; energy (5), materials (13), industrials (69), consumer discretionary (21), consumer staples (36), health care (7), financials (47), information technology (16) ,telecommunication (6) services and utilities (3). According to the industry classification Global Industry Classification Standard (GICS) that are developed for listed companies (Hrazdil & Zhang 2012). Out of 223 companies, 49 are Small Cap, 98 are Mid Cap, 76 are Large Cap, and of them 130 companies are listed today (March 2012).

3.4 Model

In this study we will use three different regression models for our statistical testing. The following variables are included in all three regression models; Δ *provisions* and *IFRS*, and the control variables are *Company size, International listing* and *Debt/equity ratio*. The data for the dependent variable is collected from Datastream. *Provision for risks and charges* in Datastream included *Provisions for pensions*. Since this type of provisions is excluded in our study, the collected data are subtracted from *Provision for risks and charges*. Since we are interested in only the yearly provisions, we calculated the yearly difference in total provisions which we have named Δ *provisions*. The term for our dependent variable is as follows:

$$\frac{\Delta provisions\ for\ risks\ and\ charges - \Delta provision\ for\ pensions}{Total\ Assets}$$

The term can be summarized as;

$$\frac{\Delta prov\ (pensions\ excl.)}{TA}.$$

The reason for dividing provisions by total assets is to be able to relate the size of the provisions to the size of the company. In order to make sure that the study is not biased, control variables are included (Blumberg *et al.,* 2008). Control variables are independent variables that are used in order to control their effect on dependent variables. The control variables included in all our three regression models are *Debt/equity ratio, Company Size* and *International listing.*

Debt/equity ratio will be used as a control variable since previous research concludes that it has an impact on earning management. In a study made by Watts and Zimmerman (1990), they state a hypothesis in which they assume that managers in companies with higher debt/equity ratio are more likely to manipulate the financial reports to increase the annual profit. Becker *et al.,* (1998) and Stalebrink (2007), support the same conclusion. Becker *et al.,* (1998) claim that high debt/equity ratio may cause income-decreasing earnings management

in companies having financial difficulty. Furthermore, debt dependency can be an incentive for managers to manipulate the financial reports since it could affect the cost of debt (Stalebrink 2007).

Company Size will be used as a control variable since previous research has concluded that company size affects earnings management. Most research regarding company size concludes that small companies in larger extent perform earning management, more than larger companies (Sun & Rath 2009; Zéghal *et al.,* 2011). Large companies usually have better internal control systems and usually produce more and better quality information than small firms (Zéghal *et al.,* 2011). To measure the company size, we used the logarithm of total assets for the years studied. Zéghal *et al.,* (2011) and Street & Gray (2002) used the same measurement when evaluating the company size.

International listing will be used as a control variable. The reason is that, if a company is listed internationally, i.e. on more than one stock exchange, it can be expected to have a greater experience in applying to international accounting standards, more than companies only listed in their home country. This means that there should also be fewer issues when they are obliged to use IFRS in their group accounting (Lundh 2009). A study by Street and Gray (2002), showed that compliance with IFRS is greater for companies that are listed on the U.S. financial market and/or foreign financial markets. In the regression models international listing is a dummy variable, where companies listed on more than one stock exchange is coded 1, otherwise 0.

Regression model (1) regarding CEO changes

$$\Delta Prov = \beta_0 + \beta_1 CEO + \beta_2 Size + \beta_3 Intl + \beta_4 D/E + \beta_5 IFRS + \beta_6 IFRS*CEO + \beta_7 Nres \text{ (1)}$$

The *CEO changes* variable is a dummy variable where the CEO change is coded 1, and 0 if there has not been a CEO change during that year. To find information about CEO changes**,** the database *Retriver Bolagsinfo* was used. The sources of information provided in Retriever are press releases, annual reports and publications from news agencies. Words that were used when searching the database were; *byte, avgång, avsked, sparken, avskedad, avsked, avgår, ny VD* and *pension.*

The *IFRS* variable is a dummy variable where values received before 2005 code 0 and code 1 for values after from 2005 and forward. In this regression (1), the dummy for Negative results will be used as a control variable since CEO changes has a high correlation with negative results.

The *CEO*IFRS* interaction is the dummy variable for *CEO* multiplied by the dummy variable *IFRS*. The multiplication is used to establish whether a CEO change after mandatory IFRS adoption leads to a decreased reporting of provisions.

Regression model (2) regarding negative results

$$\Delta Prov = \beta_0 + \beta_1 Size + \beta_2 Intl + \beta_3 D/E + \beta_4 IFRS + \beta_5 Nres + \beta_6 IFRS*Nres \ (2)$$

The *Negative result* variable is a dummy variable where negative results are coded 1 and positive results are coded 0.

The *Negative result*IFRS* interaction is the variable for negative result multiplied by the *IFRS* variable. The reason for this is to be able to establish whether a negative result after mandatory IFRS adoption leads to a decreased reporting of provisions.

Regression model (3) regarding extra large gains

$$\Delta Prov = \beta_0 + \beta_1 Size + \beta_2 Intl + \beta_3 D/E + \beta_4 IFRS + \beta_5 Exlgain + \beta_6 Exlgain*NI + \beta_7 IFRS*Exlgain*NI \ (3)$$

The independent variable *Extra large gains* is a dummy variable where the largest positive result for each company during 2002-2010 is coded 1. All other results will be coded 0. For some companies we have not received enough observations to ensure that the result is considered as especially large for the company. Therefore, we have excluded companies with 3 observations or less regarding net income.

The independent variable for *Net income* used in our regression model is net income + (Δ provisions *0.75). The reason for adding delta provisions to net income is that we do not want to include provisions in the result since we will test how provisions are affected by the net income. The reason for multiplying delta provisions with 0.75 is because of deferred taxes and we assume that the tax is approximately 30 percent.

The *Extra large gains*Net income* interaction is the variable *Extra large gains* multiplied by *Net income*. The reason for this is to be able to establish whether an extra large gain to a increased reporting of provisions i.e. the larger the result the larger the provision.

The *Extra large gains*Net income*IFRS* interaction is the dummy variable *Extra large gains* multiplied by the *Net income* variable and the dummy variable *IFRS*. The reason for this is to be able to establish whether an extra large gain after IFRS adoption leads to a decreased reporting of provisions. Net income is included in the interaction, since the larger the gain, the larger the provision.

4. Empirical results

This chapter presents the results from our statistical tests. The results from our three regression models are presented in Table 1. The hypotheses are presented one by one and responded to by interpreting Table 1. The correlations of the variables are presented in Table 2.

Table 1: The impact of IFRS adoption on provisions

$$\Delta Prov = \beta_0 + \beta_1 CEO + \beta_2 Size + \beta_3 Intl + \beta_4 D/E + \beta_5 IFRS + \beta_6 IFRS*CEO + \beta_7 Nres \ (1)$$
$$\Delta Prov = \beta_0 + \beta_1 Size + \beta_2 Intl + \beta_3 D/E + \beta_4 IFRS + \beta_5 Nres + \beta_6 IFRS*Nres \ (2)$$
$$\Delta Prov = \beta_0 + \beta_1 Size + \beta_2 Intl + \beta_3 D/E + \beta_4 IFRS + \beta_5 Exlgain + \beta_6 Exlgain*NI + \beta_7 IFRS* Exlgain *NI \ (3)$$

	(1)	(2)	(3)
Size	-0.001	-0.001	0.000
	(-0.821)	(-0.827)	(0.438)
Intl	-0.002	-0.002	-0.002
	(-1.239)	(-1.339)	(-1.579)
D/E	8.391*10^(-006)	1.08*10^(-005)	0.000
	(0.34)	(0.045)	(-0.390)
IFRS	0.002	0.002*	0.000
	(1.642)	(1.882)	(0.476)
CEO	0.009****		
	(3.446)		
IFRS*CEO	-0,006*		
	(-1.849)		
Nres	0.002	0.006***	
	(1.543)	(2.838)	
IFRS*Nres		-0.006**	
		(-2.512)	
Exlgain			0.003
			(1.174)
NI/TA			-0.002
			(-0.462)
Exlgain*NI			0.047**
			(2.241)
IFRS* Exlgain *NI			-0.055**
			(-2.518)
Constant	0.002	0.002	-0.002
	(0.336)	(0.416)	(-0.629)
N	777	945	903
Adj.R^2	0.02	0.007	0.006

* Correlation is moderately significant at the 0.10 level
** Correlation is significant at the 0.05 level
*** Correlation is significant at the 0.01 level
**** Correlation is significant at the 0.001 level

ΔProv = Δ Provisions (Pensions excluded) divided by Total Assets
NI = Net income plus Δ provisions multiplied with 0,75, divided by Total Assets
Size = Logarithm of Total Assets
Intl = Dummy variable for international listing, 1 = companies listed on two or more exchanges, 0 = else
D/E = Debt to equity ratio
IFRS = Dummy variable, 1 = after IFRS adoption, 0 = else
CEO = Dummy variable for CEO change, 1 = A year of CEO change, 0 = else
Nres = Dummy variable for negative result, 1 = A year of negative result, 0 = else
Exlgain = Dummy variable for ext 1 = A year of extra large gain, 0 = else

4.1 Regression models and hypotheses

In our study we have created three separate regression models. Regression model (1) includes CEO changes, regression model (2) includes negative results and regression model (3) includes extra large gains. All regression models include the control variables; *Company size, International listing* and *Debt/equity ratio*. These variables were not significant in any of the regression models; therefore we will not make any further comments regarding them.

H1
Big bath accounting exists in Swedish companies

Table 1 and regression model (1) show that there is a significant effect (at the 0.001 level) on *CEO*, as expected. The *CEO* term is positive which indicates that provisions[1] increase in the year of an executive change.

Table 1 and regression model (2) show that there is a significant effect (at the 0.01 level) on *Nres*, as expected. The *Nres* term is positive which indicates that provisions[1] increase in the year of a negative result.

Table 1 and regression model (3) show that there is a significant effect (at the 0.05 level) on the *Exlgain*NI interaction*, as expected. The *Exlgain*NI* term is positive which indicates that provisions**[1]** increase in the year of an extra large gain and the larger the gain the larger the provision.

Our results show that H1 cannot be rejected. According to our study, big bath accounting existed in Swedish companies during 2002-2010, when it comes to larger negative provisions in the year of a CEO change, negative result and extra large gain.

H2
Mandatory adoption of IFRS by Swedish companies contributes to the reduction of big bath accounting

Table 1 and regression model (1) show that there is a significant effect (at the 0.1 level) on the *IFRS*CEO* interaction, as expected. The *IFRS*CEO* term is negative which indicates that provisions[1] decrease in the year of an executive change after the mandatory adoption of IFRS in 2005. This indicates that the increasing effect of CEO changes on provisions[1] is reduced after 2005.

Table 1 and regression model (2) show that there is a significant effect (at the 0.05 level) on the *IFRS*Nres* interaction, as expected. The *IFRS*Nres* term is negative which indicates that provisions[1] decrease in the year of a negative result after the mandatory adoption of IFRS in

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1 $\dfrac{\Delta prov\ (pensions\ excl.)}{TA}$

2005. This indicates that the increasing effect of negative results on provisions[1] is reduced after 2005.

Table 1 and regression model (3) show that there is a significant effect (at the 0.05 level) on the *IFRS*Exlgain*NI* interaction, as expected. The *IFRS*Exlgain*NI* term is negative which indicates that provisions[1] decrease in the year of an extra large gain after the mandatory adoption of IFRS in 2005. This indicates that the increasing effect of extra large gains on provisions[1] is reduced after 2005.

Our results show that H2 cannot be rejected. According to our study, mandatory adoption of IFRS by Swedish companies contributes to the reduction of big bath accounting when it comes to larger negative provisions in the year of a CEO change, a negative result and an extra large gain. The years compared were 2002-2004 before IFRS adoption and 2005-2010 after IFRS adoption.

4.2 Correlation

Table 2: Pearson correlation matrix

Variable	ΔProv	CEO	Size	Intl	D/E	Nres	Exlgain	IFRS
ΔProv	1	0,034	-0,008	-0,053	0,002	-0,007	0,069*	0,052
CEO	0,034	1	-0,034	0,051	0,049	0,171**	-0,019	-0,067*
Size	-0,008	-0,034	1	0,263**	0,293**	-0,220**	-0,044	0,106**
Intl	-0,053	0,051	0,263**	1	-0,002	-0,029	-0,007	0,000
D/E	0,002	0,049	0,293**	-0,002	1	0,026	-0,049	0,029
Nres	-0,007	0,171**	-0,220**	-0,029	0,026	1	-0,152**	-0,091**
Exlgain	0,069*	-0,019	-0,044	-0,007	-0,049	-0,152**	1	0,150**
IFRS	0,052	-0,067*	0,106**	0,000	0,029	-0,091**	0,150**	1

* Correlation is significant at the 0.05 level
** Correlation is significant at the 0.01 level

Table 2 is a correlations matrix that shows how variables are correlated with each other. The table shows that multicollinearity is not a problem in our regression models since none of the variables are strongly correlated. A strong correlation can be defined as a correlation above 0.8. (Anderson *et al.,* 2009) The variables with the strongest significant correlation were *Size* and *International listing* (0.263) and *Size* and *Debt/equity ratio* (0.293). These correlations were far below 0.8. The variables CEO change and negative result are among the variables with the strongest significant correlation (0.171), which is why we use negative result as a control variable in regression model (1).

5. Analysis

In this chapter we discuss and analyze the results from the empirical chapter. We start with the findings for the first hypothesis, then we follow the same order as in the section empirical results for the rest of the hypotheses.

5.1 The existence of big bath accounting in Swedish companies

The results received from the empirical chapter show significance for H1, i.e. big bath accounting exists in Swedish companies when it comes to larger negative provisions in the year of an executive change, in the year of a negative results and, at last, in the year of an extra large gain. Previous research (Healy 1985; Murphy & Zimmerman 1993; Geiger & North 2011) has come to the conclusion that big bath accounting is an existing phenomenon. The results from the empirical chapter show that we have come to the same results as prior research.

When new managers take over, companies are more likely to perform big bath accounting (Riahi-Belakaoui, 2003). Geiger & North (2011), have summarized prior studies on the big bath phenomenon which found that companies appointing new CEOs are more likely to report reduced income in the initial year of the new CEO, and then report increased income in the immediately succeeding years, also the authors supported this conclusion. From the empirical results in our study we have found the same results as earlier studies, i.e. big bath accounting exists when it comes to larger negative provisions in the year of an executive change.

Previous research have found, that companies are more likely to execute big baths when earnings are particularly weak as management sees an opportunity to add additional expenses, which will most likely not even be noticed, to the current period (Riahi-Belkaoui 2003). If earnings are so low that no matter which accounting procedures are selected, target earnings will not be met, managers have incentives to further reduce current earnings, to be ensured that they could report increased income in the future (Healy 1985). Stalebrink (2007) has found evidence that supports the hypothesis regarding negative result. He found that Swedish municipalities increase the size of discretionary accruals during the year when negative results are reported. The empirical results in this study showed that larger negative provisions have increased in the year of a negative result. Our results are in accordance with prior research, i.e. big bath accounting exists when it comes to larger negative provisions in the year of a negative result.

Companies are more likely to execute big baths when a company has a large non-recurring gain. This manipulative technique is also called income smoothing. An essential characteristic for income smoothing is when managers taking actions to increase gain when it is relatively low, and to decrease gain when it is relatively high (Fudenberg & Tirole 1995). Schilit (2002)

have in his study found that companies may attempt to shift the next year's expenses into current year if they already have met their financial targets, thus preparing expenses to boost the next year profits. We have come to the same conclusion as Fudenberg & Tirole and Schilit, i.e. big bath accounting exists when it comes to larger negative provisions in the year of an extra large gain.

We have focused our study on Swedish companies regarding the existence of big bath accounting. However, little research from earlier studies has concentrated on Swedish companies. One study we found is about Swedish municipalities that showed an existence of big bath accounting in Sweden regarding negative results. From the statistical testing we have found existence of big bath accounting in Sweden in all areas, i.e. CEO changes, negative results and extra large gains. Our results implicate that earlier research regarding big bath accounting can be applied on Swedish companies, at least when it comes to provisions.

5.2 The reduction of big bath accounting after mandatory adoption of IFRS

Our empirical results show significance for a reduction of big bath accounting after the mandatory adoption, in the year of a CEO change, a negative result and an extra large gain. The results from earlier studies are ambiguous about earnings management; has it decreased after IFRS adoption or not. According to Zéghal et al., (2011) mandatory adoption of IFRS has decreased earnings management level for French companies. In contrast, Jeanjean & Stolowy (2008) claim that earnings management was not reduced after the introduction of IFRS in 2005, in none of the countries Australia, France nor United Kingdom.

The results from our statistical testing are in accordance with the study by Zéghal et al., (2011). However, the studies conducted by Zéghal et al., (2011) and Jeanjean & Stolowy (2008) had some similarities to our study but also some differences. Both study earnings management but our focus has been on a part of it, i.e. big bath accounting regarding provisions. Our study concerns Swedish listed companies while the other studies are focusing on companies in France, Australia and the United Kingdom. Another difference is that Zéghal et al., (2011) used a different approach to discretionary accruals, and Jeanjean & Stolowy (2008) studied distribution of earnings.

A possible explanation to the reduction of big bath accounting after IFRS adoption can be the extended focus on enforcement after the adoption. Lundh (2009), states that the enforcement institutions in Sweden were weak during 1991-2004. The adoption of IFRS during this period was characterized as *soft adoption* since among other reasons, listed firms only had to either comply with, or explain deviations from the RR recommendations (Hellman 2011a; Hellman 2011b). According to prior research, Ball *et al.* (2003) suggest that political forces, such as government enforcing accounting standards, are important variables that affect financial reporting practice. Also Lundh (2009) emphasizes the importance of adequate enforcement

activities and he states that without adequate enforcement, the accounting regulations are simply requirements on paper.

After the decision of mandatory adoption of IFRS the European Commission gave direction to ESMA, former CESR, to develop a common approach to enforcement and establish a framework, which became Standard no. 1 and Standard no. 2. The enforcement standards created by the CESR was seen as further steps after the decision of mandatory adoption of IFRS, taken by the EU for further harmonization between the countries regarding financial reporting (CESR 2003). However, the legal responsibility for enforcement rested with National Regulators working within the framework established by CESR. (Pope & McLeay 2011). In Sweden there are currently three enforcing bodies; *Swedish Financial Supervisory Authority* (Finansinspektionen), *The Nordic Growth Market* and *Nasdaq OMX Stockholm.* (ESMA 2011). The supervision is made by the stock exchanges, and the *Swedish Financial Supervisory Authority* has the overall responsibility over the stock exchanges. (Financial reporting.se, 2012). The awareness of the EU forming a new organization for monitoring the enforcement of IFRS standards could have been a reason for companies to sharpen their accounting practices. Still, Zéghal *et al.,* (2011*)* suggest that a stronger enforcement mechanism for the implementation of IFRS must be instituted to ensure its positive impact on the quality of accounting information.

Another factor that could explain our results is the tremendous change in the accounting field that resulted from the mandatory adoption of IFRS in 2005. According to Bichut (2005), the year 2005 was a major milestone for IFRS as many companies around the world begun to use this new financial language for their external reporting. The consequences of implementing IFRS will undoubtedly go far beyond a simple change of accounting rules by the companies concerned (Jermakowicz & Gornik-Tomaszewski 2006). Since the implementation of IFRS forced companies to review their accounting procedures, educate their staff and start a great reorganization it can be assumed that the general accounting quality has improved among the listed companies after the implementation of IFRS. Manipulated results are not useful for investors' decision-making; therefore the lack of manipulation enhances accounting quality.

An important aspect is the fact that the content of the standard for provisions has not been changed during 2002-2010. However, the application of the standard has changed after the mandatory adoption of IFRS in 2005, which might be a result of an improved enforcement of the standards and an increased focus on accounting.

6. Conclusion

In this chapter we present our conclusions from the empirical results and the analysis. Finally, we make a suggestion for further research.

The purpose of this study has been to see if companies have changed their reporting of provisions after the mandatory IFRS adoption by Swedish companies in 2005, even though the content of the standard has not been changed. We have examined whether mandatory adoption of IFRS by Swedish companies contributes to the reduction of big bath accounting regarding provisions. Firstly, we can determine the existence of big bath accounting in Sweden 2002-2010. From the statistical testing we have found increased provisions during years of CEO changes, negative results and extra large gains. Our results implicates that earlier research regarding big bath accounting can be applied on Swedish companies, at least when it comes to provisions.

Our study concludes that the mandatory adoption of IFRS by Swedish companies in 2005 contributes to the reduction of big bath accounting when it comes to larger negative provisions in the year of a CEO change, a negative result and an extra large gain. Our results were in accordance with the study by Zéghal *et al.,* (2011) and in contrast to the study by Jeanjean & Stolowy (2008). However, both studies concerned earnings management and our focus has been on a part of it, i.e. big bath accounting regarding provisions.

An important aspect of our study is the fact that the content of the standard for provisions has not been changed during 2002-2010. However, the application of the standard has changed. One main reason might be that that the accounting procedures came into greater focus when the EU decided to implement IFRS. We assume that accounting improves when it gets more attention. Another reason might be the enforcement factor, both in regards to stronger legal enforcement in 2005 and the awareness of an evolving enforcement organization within the EU. According to our study, the big bath phenomenon has decreased in Sweden after the mandatory adoption of IFRS, which implies higher accounting quality. Manipulated results is not useful for investors decision-making, therefore the lack of manipulation enhances accounting quality. Although big bath accounting regarding provisions has decreased after the adoption of IFRS in 2005, it is still a phenomenon that exists. Given these findings, it may be recommended that the EU continue to work for a further improvement of the European legal enforcement systems in accordance with the suggestion from Zéghal *et al.,* (2011).

6.1 Suggestions for further research

For further research we suggest the similar hypotheses and method used in this study, but comparing big bath accounting in Sweden with the USA or other countries or continents. It can be interesting to compare Sweden to the USA since most of earlier research that we have studied examines companies in the USA. The contribution this study will be to examine if the level of big bath accounting is higher in any nation than others. Our results implicates that

earlier research regarding big bath accounting can be applied on Swedish companies, at least when it comes to provisions. Which will indicate that management teams in both the USA and Sweden have certain similarities in the use of manipulation in accounting. Another suggestion is to make a qualitative study of the reduction of big bath accounting after the mandatory IFRS adoption. This is made by interviewing auditors and also by sending an anonymous survey to companies or auditors.

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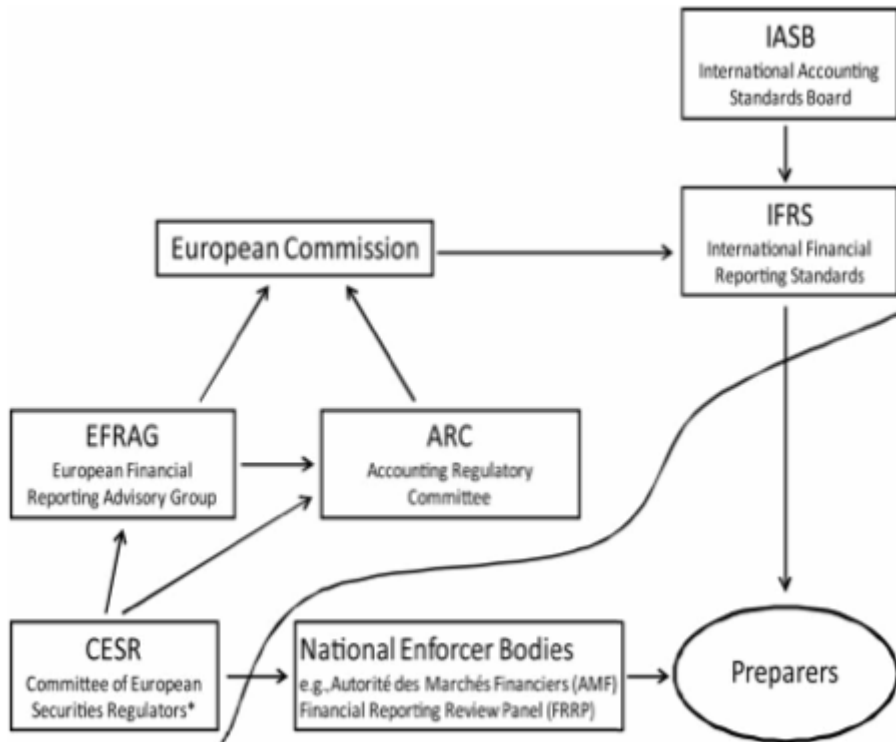
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Appendix

Appendix 1.1

The European implementation framework

*The Committee of European Securities Regulators (CESR) was replaced in 2011 by the European Securities and Markets Authority (ESMA), (Pope & McLeay 2011)

Appendix 1.2

A comparison between RR 16 (2000) and IAS 37 (2012)

RR 16, Avsättningar, Ansvarsförbindelser och Eventualtillgångar (2000)

Provisions
(14) A provision shall be recognised when:
(a) an entity a present obligation (legal or constructive) as a results of a past event;
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised.

Best Estimate
(36) The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Future events
(48) Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Presents obligation
(15) In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

IAS 37, Provisions, Contingent Liabilities and Contingent Assets (2012)

Provisions
(14) A provision shall be recognised when:
(a) an entity a present obligation (legal or constructive) as a results of a past event;
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised.

Best Estimate
(36) The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Future events
(48) Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Presents obligation
(15) In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.