Pertanika J. Soc. Sci. & Hum. 23 (S): 75 – 84 (2015)

SOCIAL SCIENCES & HUMANITIES

Journal homepage: http://www.pertanika.upm.edu.my/

IFRS Convergence and Earnings Management

Chung-Peng Khoo, Nurwati A. Ahmad-Zaluki*

Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia, Kedah, Malaysia

ABSTRACT

In this work, the extent of earnings management before and after IFRS convergence was examined. Board's characteristics (independent of board members, board size, ethnicity, and political influence) and company's characteristics (audit quality, foreign stock market listing, company size, leverage, profitability and growth) before and after IFRS convergence were also investigated. Meanwhile, the Kothari's discretionary accrual model was used to measure the extent of earnings management. Using a sample of 231 publicly listed Malaysian companies over the 2005–06 period, it was found that IFRS convergence reduced the extent of earnings management. However, board's characteristics variables did not show any significant difference before and after the IFRS convergence. As for company's characteristics, only company growth was found to have a statistically significant difference before and after the IFRS convergence.

Keywords: Political connections, IFRS, Malaysia, Earnings management

INTRODUCTION

Effective January 1, 2006, IFRS-based accounting standards that are known as Financial Reporting Standards[1] (FRS) have been employed by publicly traded companies in Malaysia. The new accounting standards that converge with IFRS are seen as a major milestone in the Malaysian accounting history after the country experienced several domestic financial scandals such as the one involving the Transmile Group Berhad.[2] These scandals have severely dented investors' confidence toward the domestic financial markets and exposed the weaknesses of the

[1] FRS and IFRS are used interchangeably throughout the paper.

[2] In a special audit, the Transmile Group Berhad was found to have overstated its revenues by more than RM500 million in FY 2005 and 2006 (The Edge Malaysia, 2009).

ARTICLE INFO

Article history:
Received: 15 December 2014
Accepted: 22 April 2015

E-mail addresses:
kcp01@gmail.com (Chung-Peng Khoo),
nurwati@uum.edu.my (Nurwati A. Ahmad-Zaluki)
* Corresponding author

ISSN: 0128-7702

current accounting regime in Malaysia. As a result, many investors seek opportunities in well-regulated foreign financial markets.

Ball, Robin, and Wu (2003) argued that even though Malaysian accounting standards have originated from common law sources (i.e., United Kingdom and International Accounting Standards), financial reporting quality in Malaysia is not better than that of code law countries because the preparers' incentives are low. Their assertion is supported by Leuz, Nanda, and Wysocki (2003), who also found that Malaysia has the least-stringent earnings management as compared with other common law countries.

Even though Malaysia is classified as a common law country, it has some similarities with the code law ones as it has a highly concentrated ownership structure (e.g., family control) and relies on insider financing such as through banks (Ball *et al*., 2003; Abdul Rahman & Mohamed Ali, 2006). Claessens, Djankov, and Lang (2000) reported that in 1996, 67.2% and 13.4% of the Malaysian publicly listed companies were under family control and state control, respectively. Moreover, the management's and owner's roles are not seggregated in family-controlled companies. Large shareholders enjoy significant decision-making power because of their management role, and in most of the cases, minority shareholders' interests are neglected. This information asymmetry problem can be solved between management and large shareholders (usually within family members) through informal channels; nevertheless, it still exists between management and minority shareholders (Siregar & Utama, 2008). The inadequacy of legal protection in Malaysia is potentially causing minority shareholders to be expropriated by management and large shareholders (Mohd Saleh, Mohd Iskandar, & Rahmat, 2007). Meanwhile, Claessens *et al*. (2000) suggested that the concentration of wealth among few families is not a good sign for equity markets, especially in the evolution of corporate governance. This could be one of the plausible reasons why Malaysia has been perceived as the country with the least-stringent earnings management among other common law countries (Leuz *et al*., 2003).

International Accounting Standard (IAS) was employed as early as 1979 and almost all of the standards were incorporated in the Malaysian financial reporting standards, known as the MASB Standards. Malaysian accounting development is closely connected with IASB as it is a major force in shaping its framework (Ball *et al*., 2003). The rationale behind the introduction of an IFRS-compliant accounting framework by MASB, which is used by more than 100 countries, is to facilitate comparability across countries and increase the transparency of financial markets. The convergence to IFRS-compliant accounting framework is also intended to counter growing competition in the global financial markets, as well as to strengthen capital and financial markets in Malaysia.

IASB is an independent accounting standards setter with the objective to develop and promote a single set of high-quality globally accepted international financial reporting standards. The ultimate objectives of the accounting body are to enhance the transparency and comparability of financial statements across the world. IASB has engaged in awareness campaigns with the help of like-minded lobbies in various countries to ensure these objectives are met. Furthermore, several major changes, such as the Comparability and Improvement Project of 1989, have been made by the IASB on IFRS to eliminate accounting choices and facilitate comparisons across countries (Leuz *et al*., 2003; Christensen, Lee, & Walker, 2008).

One of the major successes of the IASB in promoting international accounting standards is the implementation of IFRS in European countries, which started in 2005 (Barth, Landsman, & Lang, 2008; Zéghal, Chtourou, & Sellami, 2011). The wide adoption of IFRS in Europe has spurred other countries to follow; in addition to the European Union, more than 100 countries such as Argentina, Australia, and Brazil have started to recognise and use IFRS after sustained efforts made by the IASB. Many countries, including major economies such as the United States, have drawn out a roadmap to comply with IFRS and are scheduled to adopt or converge with it in the near future. Furthermore, adoption of IFRS is recommended by the International Organization of Securities Commissions (IOSCO) to its members as the cross-listing financial reporting standard (Ball, 2006). As such, securities market surveillance could become more effective and well-regulated under a single set of uniform accounting standards (El-Gazzar, Finn, & Jacob, 1999). This suggests that there are an increasing number of countries that would use IFRS as their financial reporting standard in the coming years.

Our study examined whether IFRS convergence in Malaysia, a common law country, would reduce the extent of earnings management. Using a sample of 231 Malaysian publicly listed companies over the 2005–06 period, it was found that IFRS convergence reduced the extent of earnings management.

The remainder of the paper is organised as follows. Section 2 reviews the relevant existing literature, while Section 3 discusses the research methods. Section 4 reports on the results and findings of the study. Finally, Section 5 summarises and concludes the paper.

PRIOR STUDIES ON IFRS AND EARNINGS MANAGEMENT

Most of the current debate focuses on the impacts of mandatory adoption of IFRS on earnings management. However, only a few studies have been done to examine the impacts of voluntary adoption of IFRS on earnings management (Van Tendeloo & Vanstraelen, 2005; Barth *et al*., 2008; Christensen *et al*., 2008). A remarkable study has been done by Van Tendeloo and Vanstraelen (2005) that examined the impact of voluntary adoption of IFRS.

Interestingly, they found no difference in the extent of earnings management between voluntary IFRS adopters and non-IFRS adopters in Germany's publicly traded companies. On the contrary, Christensen *et al*. (2008) found that voluntary IFRS adopters in Germany's publicly listed companies are associated with lower earnings management. In contrast to Van Tendeloo and Vanstraelen (2005), Zéghal *et al*. (2011) found that mandatory adoption of IFRS in a code law country (namely, France) led to a reduction in the extent of earnings management.

In a similar vein, Wan Ismail *et al*. (2013) used Malaysian listed companies as the subjects of the study to examine the interaction between mandatory adoption of international accounting standards and earnings management. They discovered that lower earnings management and higher value relevant were reported under the new accounting standards. The present study is different compared to the study conducted by Wan Ismail *et al*. (2013) in terms of the methods used to measure earnings management. They used modified Jones' model to measure the extent of earnings management with the time frame of three years before and after IFRS convergence.

Most of the studies with respect to earnings management are country-specific and focus on either code law or common law countries, except for Barth *et al*. (2008), whose study concentrates on the effects of voluntary IFRS adoption towards accounting quality through cross-country analysis that involves 327 companies in both code law and common law countries. Barth *et al*. (2008) revealed that companies that voluntary adopted IAS from 21 countries displayed lower earnings management, higher value relevance, and more timely loss recognition as compared with a collective sample of companies that used domestic accounting standards.

The interaction between IFRS adoption and earnings management has been tested extensively in prior studies (e.g., Van Tendeloo & Vanstraelen, 2005; Barth *et al*., 2008; Christensen *et al*., 2008; Iatridis, 2010). Most of the prior research reached a consensus that adoption of IFRS would lead to a reduction in the extent of earnings management since it requires higher disclosure and contains fewer accounting choices (Barth *et al*., 2008; Christensen *et al*., 2008; Zéghal *et al*., 2011). Hence, the following hypothesis was proposed in this study:

H_1: The extent of earnings management declines after IFRS convergence.

RESEARCH METHODS

Research design

This study focused on Malaysian companies listed on Bursa Malaysia with a December 31 financial year-end. Nonetheless, banks and financial institutions were excluded as their financial reporting rules are in accordance with the Malaysian Banking Act of 1973 issued by the Central Bank of Malaysia. In addition, pension funds and brokerage companies were also excluded since their accounting measures are incomparable with those of industrial companies. The timeframe of our study was the year 2005 (i.e., before IFRS convergence) and 2006 (i.e., after IFRS convergence). As the convergence with FRS is effective from January 1, 2006, the first annual reports prepared under IFRS would be the listed companies with a December 31 financial year-end. Hence, data for 2005 and 2006 were collected to compare the extent of earnings management under two sets of accounting standards.

Sample

The sources of data were primarily from Datastream and company annual reports obtained through the Bursa Malaysia website. A cross check was performed on the 2005 and 2006 annual reports for each sample company to ensure that they switched from the MASB standards to FRS on January 1, 2006. All the sample companies had a mandatory requirement to comply with FRS and no early adopters were found.

Our initial sample size was 847 Malaysian publicly listed companies in 2006, which was further reduced to 231 because certain companies did not fulfil the selection criteria. The study excluded 303 companies with the financial year-end other than December 31, whereas 74 IPO companies and 17 companies involved in change of financial year-end in the years 2004, 2005, and 2006, respectively, in order to enhance the comparability and consistency of the data. Furthermore, 25 banks and financial institutions were also excluded (Van Tendeloo & Vanstraelen, 2005; Iatridis, 2010; Zéghal *et al*., 2011) since they are subject to different financial reporting rules in accordance with the Malaysian Banking Act of 1973. In addition, 173 companies in the industry groups containing less than 10 companies were also excluded since the cross-sectional regression for each industry is required to es*timate discretionary accrual (Chen et al*., 2005; Zéghal *et al*., 2011). Another 24 companies with insufficient data were also excluded from this study. The final sample consisted of 231 companies from diverse sectors, as described in Table 1 below.

TABLE 1
Industrial Sector of Sample Companies

Industry	Number of Companies	Percentage (%)
Building materials and fixtures	32	13.85
Computer services	12	5.19
Container and packages	17	7.36
Electrical equipment	11	4.76
Farming and fishing	23	9.96
Food products	16	6.93

TABLE 1 (continue)

Furnishings	10	4.33
Heavy construction	22	9.52
Industrial machinery	22	9.52
Iron and steel	10	4.33
Real estate holdings development	32	13.85
Software	14	6.06
Transport services	10	4.33
Total	231	100.00

Source: Sample Source

Operational Definitions and Measurement of the Variables

Earnings management was used as the metric to proxy the quality of the information contained in the financial statements. Similar to Zéghal *et al*. (2011), Kothari *et al*.'s (2005) discretionary accruals model, as specified in Equation 1, was used to estimate the discretionary accruals for each company in the industry group with at least 10 companies. We are interested in the discretionary accruals, (i.e., residuals value, υ_{it}), which are obtained through Equation 2.

$$TACC_{it} = \alpha_0 + \beta_1(1/TA_{it-1}) + \beta_2(\Delta REV_{it} - \Delta REC_{it}) + \beta_3 GPPE_{it} + \beta_4 ROA_{it} + \upsilon_{it} \quad (1)$$

$$DACC_{it} = TACC_{it} - [\alpha_0 + \beta_1(1/TA_{it-1}) + \beta_2(\Delta REV_{it} - \Delta REC_{it}) + \beta_3 GPPE_{it} + \beta_4 ROA_{it}] \quad (2)$$

Where $TACC_{it}$ represents the total accruals for the company *i* in year *t*; $DACC_{it}$, discretionary accruals for the company *i* in year *t*; TA_{it-1}, lagged total assets for the company *i* in year *t*-1; ΔREV_{it}, annual change in the revenues for the company *i* between year *t* and year *t*-1; ΔREC_{it}, annual change in receivables for the company *i* between year *t* and year *t*-1; $GPPE_{it}$, net property, plant, and equipment for the company *i* in year *t*; and ROA_{it}, return on assets for the company *i* in year *t*. Consistent with some prior studies (e.g., Abdul Rahman, & Mohamed Ali, 2006; Ahmad-Zaluki, Campbell, & Goodacre, 2011; Zéghal *et al*., 2011), all the variables were deflated by lagged total assets to reduce the heteroskedasticity of the data.

The current study was concerned with the absolute value of discretionary accruals (i.e., $|DACC_{it}|$) as it disregarded whether the earnings were managed up or down (Abdul Rahman, & Mohamed Ali, 2006; Zéghal *et al*., 2011). Once the absolute discretionary accrual values were calculated for the companies, paired-samples t-test was used to compare the extent of earnings management before and after the IFRS convergence.

RESULTS

A univariate analysis was performed to test the hypothesis (H_1), which examines whether the extent of earnings management reduces after the IFRS convergence. The results obtained after comparing the before and after IFRS convergence data are reported in Table 2. Panels A, B and C report the results of earnings management variables, board characteristrics and company characteristics, respectively. Based on the results of the absolute discretionary accruals (|DACC|), it was found that the companies reporting under the MASB Standards (before IFRS convergence) showed on average 5.98% earnings management, while the figure for those reporting under IFRS (after IFRS convergence) was 4.17% on average. This finding implies that there is a significant decline in earnings management after the IFRS convergence. Therefore, it can be concluded that with a paired sample t-test of -3.991, one can successfully reject the null hypothesis and reveal a statistical difference between absolute discretionary accruals before and after the IFRS convergence.

Since the earnings management variable does not satisfy the normality assumption, a non-parametric test (i.e., Wilcoxon's signed rank test) is performed to check the robustness of the results that are reported under the paired samples t-test. Consistent with the paired sample t-test results, the results of the non-parametric test (z=-3.417) reveal that there is a statistically significant difference in absolute discretionary accruals before and after the IFRS convergence.[3] Consequently, it can be concluded that Hypothesis H_1 is verified, i.e. the IFRS convergence reduces the extent of earnings management. However, the other two earnings management variables (DACC and DACC>0) did not show any significant difference before and after IFRS convergence, except for the variable DACC<0, which shows a significant difference between the two periods.

[3] Effect size analysis is performed to ensure that the decline in discretionary accruals is unlikely occur by chance. Eta squared = t2/ (t2+N-1) is used to measure the effect size statistic. According to Cohen (1988), the Eta Squared is considered to have moderate effect if the value falls within the range of 0.06 to 0.14. The Eta Squared value of our study is 0.0647. This indicates that there is a moderate effect, with a substantial difference in the absolute discretionary accruals before and after IFRS convergence. In other words, the change from the MASB Standards to IFRS has a moderate effect in explaining the decline in discretionary accruals.

TABLE 2
Results of Univariate Analysis

Variables (n=231)	Mean (Pre-IFRS)	Mean (Post-IFRS)	Correlation	Paired Samples t-test	Wilcoxon Signed Rank test	Chi-Square
Panel A: Earnings Management Variables						
				–	–	
|DACC|	0.059	0.042	0.283***	-3.991***	-3.417***	N/A
DACC	-0.009	0.000	0.000	1.321	1.502	N/A
DACC≥ 0	0.058	0.046	0.126	-1.518	-1.038	N/A
DACC<0	-0.062	-0.039	0.073	3.272***	2.740**	N/A
Panel B: Board's Characteristics						
INDBM	0.398	0.405	0.815***	1.628	1.404	N/A
BSIZE	7.312	7.294	0.891***	-0.306	-0.031	N/A
ETHNI	0.351	0.348	0.971***	0.680	0.853	N/A
NPCON	0.795	0.799	0.929***	0.918	0.887	N/A
Panel C: C0mpany's Characteristics						
AQUAL	0.524	0.528	N/A	N/A	N/A	215.252***
DFEXM	0.069	0.069	N/A	N/A	N/A	215.748***
CSIZE	422.711	436.568	0.979***	1.421	4.004***	N/A
LEVER	22.103	22.495	0.928***	0.862	1.008	N/A
PROFIT	20.778	55.827	0.112**	1.043	0.434	N/A
GROWT	0.899	1.069	0.787***	3.484***	5.527***	N/A

Note: Sample size (Pre-IFRS)/(Post-IFRS) for DACC≥ 0 (n=101)/(n=109) and DACC<0 (n=130)/(122)

|DACC|: Absolute discretionary accruals; DACC: Discretionary accruals; DACC≥ 0: Positive discretionary accruals; DACC<0: Negative discretionary accruals; INDBM: Proportion of independence of board members; BSIZE: Total number of directors; ETHNI: Proportion of Malay directors on the board; NPCON: Proportion of politically unconnected directors on the board; AQUAL: Big-4 auditors; DFEXM: Foreign stock market listing; CSIZE: Total assets (in million RM); LEVER: Total debt-to-total assets (in percentage); PROFIT: Cash flow from operations (in million RM); GROWT: Price-to-book value ratio; N/A: Not applicable; ***, **, and * indicate significance level at 1%, 5%, and 10%, respectively.

As reported in Panel B, the average percentage of the independent external directors on board in the sample companies before and after IFRS convergence is 39.84% and 40.49%, respectively. Board size for the sample companies is about 7 members for both before and after the IFRS convergence. On average, there are 35.10% and 34.81% Malay directors on board before and after the IFRS convergence. The percentage of directors who do not have the political influence before and after IFRS convergence is 79.49% and 79.93%, respectively.

The results of company's characteristics reported in Panel C show that about 52.38% and 52.81% of sample companies are audited by Big-4 auditors before and after the IFRS convergence, respectively. However, only 6.93% of the sample companies are listed on the foreign stock markets before and after the IFRS convergence. The average value of the total assets before and after the IFRS convergence is RM422,711,480 and RM436,568,152, respectively. There is an average 22.10% and 22.50% of leverage before and after the IFRS convergence, respectively. As for cash inflow from operating activities, the average is RM20,777,628 and RM55,821,727 before and after IFRS convergence, respectively. The average market value is lower than the book value in the sample companies and it is underestimated; it increased to 1.069 after the IFRS convergence. This implies that the average market value is almost equal to the book value in the sample companies, suggesting that the true value of a company is fairly reflected in the market price. Other than |DACC| and DACC<0, GROWT was also found to have a statistically significant difference (i.e., both parametric and non-parametric techniques) between before and after the IFRS convergence. However, CSIZE was found to have a statistically significant difference only in the non-parametric analysis. Other variables such as LEVER and PROFIT did not have any significant difference before and after the IFRS convergence.

CONCLUSION AND SUMMARY

As reported by Ball *et al*. (2003) and Leuz *et al*. (2003), earnings management is prevalent in Malaysia. As evident in some prior studies (e.g., Barth *et al*., 2008; Christensen *et al*., 2008; Zéghal *et al*., 2011), IFRS could reduce the extent of earnings management since the Standards contain lesser accounting choices and require higher disclosure requirements. Therefore, we have investigated whether the convergence toward IFRS can reduce the extent of earnings management among selected Malaysian publicly listed companies. The evidence shows that the IFRS convergence reduces earnings management practices among the Malaysian publicly traded companies.

The current study contributes to the body of knowledge in relation to the impacts of IFRS convergence on earnings management in an Asian country. The findings have implications for regulatory bodies, which seek to look into the effects of IFRS convergence on potential earnings management reported under IFRS. In addition, this research is also important for investors and financial analysts as it provides empirical evidence that shows the reliability of financial information reported under IFRS in Malaysia. The conclusions provide additional evidence for regulatory bodies in other Asian or developing countries with a similar context to Malaysia so as to make a decision regarding conversion to IFRS.

REFERENCES

Abdul Rahman, R., & Mohamed Ali, F. H. (2006). Board, Audit Committee, Culture and Earnings Management: Malaysian Evidence. *Managerial Auditing Journal, 21*(7), 783-804.

Ahmad-Zaluki, N. A., Campbell, K., & Goodacre, A. (2011). Earnings Management in Malaysian IPOs: The East Asian Crisis, Ownership Control, and Post-IPO Performance. *International Journal of Accounting, 46*(2), 111-137.

Ball, R. (2006). International Financial Reporting Standards: Pros and Cons for Investors. *Accounting and Business Research, International Accounting Policy Forum,* 5-27.

Ball, R., Robin, A., & Wu, J. S. (2003). Incentives versus Standards: Properties of Accounting Income in Four East Asian Countries. *Journal of Accounting and Economics, 36*, 235-270.

Barth, M. E., Landsman, W. R., & Lang, M. H. (2008). International Accounting Standards and Accounting Quality. *Journal of Accounting Research, 46*(3), 467-497.

Chen, K. Y., Lin, K. L., & Zhou, J. (2005). Audit Quality and Earnings Management for Taiwan IPO Firms. *Managerial Auditing Journal, 20*(1), 86-104.

Christensen, H. B., Lee, E., & Walker, M. (2008). Incentives or Standards: What Determines Accounting Quality Changes around IFRS Adoption? *Financial Accounting and Reporting Section FARS*.

Claessens, S., Djankov, S., & Lang, L. (2000). The Separation of Ownership and Control in East Asian Corporations. *Journal of Financial Economics, 58*, 81-112.

El-Gazzar, S. M., Finn, P. M., & Jacob, R. (1999). An Empirical Investigation of Multinational Firms' Compliance with International Accounting Standards, *International Journal of Accounting, 34*(2), 239-248.

Kothari, S. P., Leone, A. J., & Wasley, C. E. (2005). Performance Matched Discretionary Accrual Measures. *Journal of Accounting and Economics, 39*(1), 163-197.

Leuz, C., Nanda, D., & Wysocki, P. D. (2003). Earnings Management and Investor Protection: An International Comparison. *Journal of Financial Economics, 69*, 505-527.

Mohd Saleh, N., Mohd Iskandar, T., & Rahmat, M. M. (2007). Audit Committee Characteristics and Earnings Management: Evidence from Malaysia. *Asian Review of Accounting, 15*(2), 147-163.

Siregar, S. V., & Utama, S. (2008). Type of Earnings Management and the Effect of Ownership Structure, Firm Size, and Corporate-Governance Practices: Evidence from Indonesia. *International Journal of Accounting, 43*, 1-27.

The Edge Malaysia. (2009, August 17). *Cover Story: Learning from Corporate Scandals*. Retrieved June 6, 2013, from The Edge Malaysia: http://www.theedgemalaysia.com/first/148907-cover-story-learning-from-corporate-scandals.html

Van Tendeloo, B., & Vanstraelen, A. (2005). Earnings Management under German GAAP versus IFRS. *European Accounting Review, 14*(1), 155-180.

Wan Ismail, W. A., Kamarudin, K. A., van Zijil, T., & Dunstan, K. (2013). Earnings Quality and the Adoption of IFRS-Based Accounting Standards: Evidence from an Emerging Market. *Asian Review of Accounting, 21*(1), 55-73.

Zéghal, D., Chtourou, S., & Sellami, Y. M. (2011). An Analysis of the Effect of Mandatory Adoption of IAS/IFRS on Earnings Management. *Journal of International Accounting, Auditing and Taxation, 20*, 61-72.