Earnings Quality of Accounting Information after IFRS Adoption: An Empirical Study of Thai Listed Firms after IFRS Adoption

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Abstract

IFRS adoption in Thailand in 2011 has led to a concern regarding earnings quality of accounting information due to economic and social environments. Although it is arguable that convergence with IFRS improves the quality of financial reporting and provides better communication on meaningful information to the stakeholders,some researchers assert that IFRS is irrelevant to developing countries due to differences in cultural, economic and political contexts. As a consequence, this study examines the earnings quality of accounting informationprepared after first-time IFRS adoption in a Thai context. Earnings quality

is measured in terms of accrual quality. We focus our analysis on the sample firms listed on Thailand's SET 100 index over the period 2011 through 2014. Based on our sample of 220 firm year observations, the main result indicates that earnings quality measuredin terms of accrual quality are relatively stable over the sample period, although there were two new mandatory IAS, namely deferred tax (IAS No. 12) and accounting for government grants and disclosure (IAS No.20)in 2013, twenty eight mandatory IFRS revisions (2012) in 2011 and eighteen mandatory IFRS revisions (2012) in 2014. This implies that reported earnings are not extensively improved in the sample period. It can be suggested that further research should be conducted by studying informativeness of eachIAS or IFRS to provide concise information of earnings quality affected by IFRS adoption.

Key words: IFRS adoption; Earnings Quality; Accrual quality

1. INTRODUCTION

The adoption of International Financial Reporting Standards (IFRS) for listed companies in many countries around the world is one of the most significant regulatory changes in accounting history. Thailand subsequently introduced the reform of the accounting profession and accounting standards,and has made improvements in corporate governance after the financial crisis of 1997. The Federation of Accounting Professions(FAP), a standard setting body, has compliedin material respects with international accounting standards (IASs) and international financial reporting standards (IFRSs) in Thailand. Since January1, 2011, all listed companies in the Stock Exchange of Thailand have been required to publishtheir financial statements in accordance with International Financial Reporting Standards (IFRSs). The full adoption of IFRS in Thailand in 2011 has led to a concern regarding the earnings quality of accounting information due to the economic and social environment. On January1,2013, listed companies in the Stock Exchange of Thailand, had new mandatory IASs, namely deferred tax (IAS No.12) and accounting for government grants and disclosure of government assistance (IAS No.20) and eighteen mandatory IFRS revisions (2012) in 2014. The Adoption of IFRS has resulted in changes in the contents of financial statements and in perceptions of the quality of Thai financial reporting includingthe earnings quality of accounting information. There is a consensus on the fact that the quality of financial reporting is essential to its users who require useful accounting information for decision-making purposes.

The objective of this research is to examine the earnings quality of accounting information after first – time IFRS adoption. This paper is organized as follows. In the following section, we present the literature review. In the third section, we present the research design. In the fourth section discusses the results, and the fifth section is the conclusion.

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2. LITERATURE REVIEW

2.1 Mandatory adoption IFRS

The study of financial reporting quality – before and after IFRS adoption found that IFRS adoption increased the qualitative characteristics of financial reporting.Thequalitative characteristics are relevance, understandability and comparability level, whichall increased after IFRS adoption

(Yurisandi and Puspitasari .2015).The study of thevalue relevanceof IFRSwas then carried out. In the case of GCC countries, the findings showed a slight difference in the value relevance of accounting information after the adoption of IFRS by listed companiesin BHB (Mousa and Desoky .2014). Many studies have examined the economic consequences of the adoption of IFRS throughout the world ,and provided evidence indicating that IFRS adoption generally improves the quality of accounting information (Barth et al. 2008) and reduces the cost of equity capital (Daske et al. 2008; Li 2010), although the effects could vary by country and firm.

Previous studies provide some evidence that voluntary IFRS adoption improves earnings quality (Bartovet al.2005; Gassen and Sellhorn 2006; Barth et al.2008). The mandatory adoption of IFRS is associated with less earnings smoothing, less managing toward a target,a decrease in absolute discretionary accruals, and an increase in accruals quality (Zeghalet al.2012).

In addition, the study of the effects of mandatory IFRS adoption on accounting quality critically depends upon whether the IFRS is of higher or lower quality than domestic GAAP and how it affects the efficiency of enforcement mechanisms. By a higher quality standard they mean a standard thateither reduces managerial discretion over accounting choices or inherently disallows smoothing or the overstatement of earnings. If the quality of IFRS is higher than domestic GAAP, and is appropriately enforced, the mandatory adoption ofIFRS could be expectedto improve accounting quality (Ahmed et al.2013). Finally, finding the difference in earnings quality from the pre- to post-IFRS period is not different for the cross-listed and matched firms when earnings quality is measured by absolute discretionary accruals, timely loss recognition, or a long-window ERC. However, for the incidence of small positive earnings and earnings persistence, for which there are significant differences and similarities, IFRS adoption led to an improvement in earnings quality for cross-listed firms relative to the matched firms (Sun et al.2011).

2.2 Definition and indicators to measure Earnings Quality

The quality of earnings is usually defined in accounting studies from two different perspectives, the decision-usefulness perspective and the economics-based perspective. From a decision-usefulness perspective, earnings quality is regarded as being high if the earnings numbers are useful for decision making purposes. Based on this point of view, the notion of earnings quality is defined differently by different users of financial statements (Kamarudin K.A. and Ismail.W.A.W.2014)

Investors are likely to evaluate the performance of the company, assess the extent to which current earnings indicate future performance and determine whether the current stock price reflects intrinsic firm value (Dechow and Schrand, 2004). On the other hand, creditors and compensation committees may define high quality earnings as earnings that are easily convertible into cash flows and that reflect managers' real performance (Kamarudin K.A. and Ismail.W.A.W.2014)

Shipper and Vincent (2003, p. 98) defined earnings quality as "the extent to which reported earnings faithfully represent Hicksian income, where representational faithfulness means correspondence or agreement between a measure or description and the phenomenon that it purports to represent". This construct measures the quality of earnings based on its correlation with 'true earnings', which does not depend on accounting recognition rules and the implementation of the accounting rules. 'True earnings' is a neutral and context-free benchmark, yet difficult to assess as Hicksian income is not observable. However, since Hicksian earnings are not observable, the construct is not operational.

Francis et al. (2004) examined the relation between the cost of equity capital and seven attributes of earnings: accrual quality, persistence, predictability, smoothness, value relevance, timeliness, and conservatism. They characterized thefirst four attributes as accounting-based because they are typically measured using only accounting information. They characterized the last three attributes as market-based because proxies for these constructs are typically based on relations between market data and accounting data. They found that firms with the least favorable value for each attribute, considered individually, generally experienced larger costs of equity than firms with the most favorable values. The largest cost of equity effects were observed for the accounting-based attributes, in particular, accrual quality.

Previous research defined earnings quality throughseveral attributes such as persistence or sustainability, predictive ability, smoothness, conservatism, value-relevance, timeliness, earnings management and accrual quality. For this paper, we examine earnings quality by measuring accrual quality as accounting-based perspectivesbecause this indicator is suitable for proving the effect of IFRS adoption.

Accrual Quality

The difference between cash from operating and recorded earnings generated by business indicates accrual quality (Richardson et al. 2003, Desai et al. 2006,Lyimo.2014). Likewise, the assessment of errors in estimating the accrual has also been used in measuring the quality of accrual (Lyimo.2014). A large value obtained from each method implies poor earnings quality and a small value obtained from each method indicates high quality earnings.

Warfield, Wild, and Wild (1995) examined the level of managerial ownership which affects both the informativeness of earnings and the magnitude of discretionary accounting accrual adjustments. Results show that managerial ownership is positively associated with the explanatory power of earnings for returns and is inversely related to the magnitude of accounting accrual adjustments. Moreover, ownership is less important for regulated corporations, suggesting regulation monitors managers' accounting choices.

Consistent with this, Ballesta and Meca (2007) showed that the main ownership structure mechanism that affects firm value is ownership concentration. The findings suggest that ownership concentration appears to influence firm value favourably, but at high levels a detrimental effect causes market valuation to be negatively affected by high levels of large shareholder ownership. These findings, which are different from the linear or non significant relationships found in other countries, can be explained by the differences in corporate governance systems.

Kabir, Sharma, Islam and Salat (2011) examined the association between Big 4 affiliated auditors and accruals quality in Bangladesh. They suggested that the association between Big 4 affiliates and accruals quality in Bangladesh depends on measures of accrual quality and the accrual model used.

Dechow and Dichev (2002) and Sloan (1996) discussed the quality of accruals and earnings. They found that accrual quality is positively related to earnings persistence.

McNichols (2002) developed the earnings quality model of Dechow and Dichev (2002) with model earnings quality as the magnitude of estimation errors in accruals, and provided empirical estimates of this construct based on the relation between accruals and cash flows. The research characterizes the innovation and limitations of this approach, and providesempirical evidence of measurement errors in their empirical specification. The research also adapted their model to assess the specification of the Jones' (1991) model and documented that this model provides estimates of discretionary accruals that are significantly associated with cash flows, which are likely to be substantially nondiscretionary.

2.3 Hypothesis Development

Based on our literature review, the hypothesis developed as follows:

Hypothesis:

Earnings quality measured in terms of accrual quality has been significantly different over the period 2011 through 2014.

3. RESEARCH DESIGN

3.1 Empirical Design

This purpose of this research is to examinethe earnings quality of accounting information prepared after first-time IFRS adoption in a Thai context. To achieve this, the one-way analysis of variance (ANOVA) is used to determine whether there are any significant differences between the means of earnings quality indicatorsover the period 2011 through 2014.

In this research, we measured earnings quality in terms ofaccrual quality. We adopted the models used by Richardson (2003) and Desai et al. (2006) to measure accrual quality. The model isdiscussed below:

Accrual quality focuses on the difference between cash flow from operational and recorded earnings generated by business. A large value indicates low earnings quality and a small value indicates high earnings quality. The equation to compute accrual quality is presented below:

Accrual Quality = (Earnings – CFO) / Average Assets (1)

Where,

Earnings = earnings after tax

CFO = cash flow from operation

Average Assets = (beginning assets + ending assets)/2

3.2 Sample

Listed firms onthe Stock Exchange of Thailand (SET) that also belong on the SET100 Index are used as the subjects in this research. The SET100 Index consists of firms which are listed onthe Stock Exchange of Thailand with the highest market capitalizations. Therefore, these firms could work as representives of IFRS adoption in Thailand. Our sample period is four years spanning from 2011 to 2014. However, we excluded all banking and finance firms and firms without enough information for computing all indicators of earnings quality. Therefore, the available complete data were for only 220 firm year observations.

4. RESULTS

Table 1 presents the result of testing whether there are any significant differences between the means of accrual quality over the period 2011 through 2014.

The one-way analysis of variance (ANOVA) is used toexamine the questions. The independent variable represented the years after first-time IFRS adoption with four groups being represented: 1) 2011; 2) 2012; 3) 2013; and 4) 2014. The dependent variables wasaccrual quality,computed on the basis of equation 1.

For hypothesistesting,earnings quality measured in terms of accrual quality are significantly differentover the period 2011 through 2014. The Levene's F test revealed that the homogeneity of various assumptions was not met ($p = 0.09$). As such, the Welch's F test was used. An analysis of variance showed that after first-time IFRSadoption (over the period 2011 through2014) there were nosignificant differences between the means of accrual quality, Welchl's $F(3, 110.80) = 1.227$, $p>0.05$.

5. CONCLUSION

The main result indicates that earnings qualitywasrelatively stable over the period of after first-time IFRS adoption (2011 through 2014). It implies that the implementation of the new set of IFRS does not extensively improve earnings quality. Our findings contrast with findings in earlier studies which suggested that IFRS adoption leads to an increase in earnings quality. We presumed our empirical result can be explained in various ways. For instance, an increase in earnings quality may result from other factors such as the economic situation, the legal system and cultural factors. Luez et al. (2003) and Ball (2001) explained that IFRS adoption alone may not be adequately explain a variation in the earnings management level. Other country-specific factors such as the legal system, the enforcement of law, investor protection and corporate governance are important determinants of the quality of financial reporting. Ahmed et al. (2013) provided the result that the quality of domestic GAAP and the efficacy of enforcement are also important factors to improve the quality of financial reporting.

Table 1: Earnings quality result and ANOVA result

Earnings Quality Indicator	Year	n	Means	SD	F	Sig. (2-tailed)
Accrual Quality	1	55	1.27	8.73	1.23 1	0.31
	2	55	0.07	0.58		
	3	55	0.06	0.67		
	4	55	0.11	0.15		
	4	55	3.00	5.29		

Note: 1 = Welch's F Test

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