

Conceptual Framework for IFRS Adoption, Audit Quality and Earnings Management: The Case of Bangladesh

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Abstract

This study propose to explore the moderating role of audit quality on the relationship between IFRS adoption and earnings management as well as the effect of IFRS adoption on earnings management in the context of Bangladesh, as developing economy. Earlier literature document that the relationship among IFRS adoption, audit quality and earnings management are not conclusive. In case of IFRS adoption, it is incoherent which may be the result of difference in culture, practices and legal strength of the country. This study considers discretionary accruals as proxy of earnings management which is measured by the extended modified Jones model. Moreover, the influence of audit quality on the association between IFRS adoption and earnings management is also proposed to investigate. This study expects to explore the effect of IFRS adoption on earnings management in the context of developing country, like Bangladesh. It may be informative for the reader to understand the outcome of IFRS adoption, audit quality on earnings management in developing economy.

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INTRODUCTION

Accounting is considered as an art or science to communicate business information through financial statements. A global demand raise the issue to have a common language for financial reporting. In response to the demand, IASB has issued International Financial Reporting Standards as a distinct set of accounting standards for all, which has been adopted by more than 130 countries around the world ("Deloitte: IAS Plus," October 26, 2016). Consequently, IFRS have substantial contribution to the uniformity of financial reporting over the world. It becomes easier for investors to get required information and make comparison among several investment decisions. In addition, it will also help to reduce the cost of information for multinational companies because of the uniform structure of financial reporting. Soderstrom and Sun (2007) argue that a single set of accounting standards will put managers under pressure due to accessibility and comparability of information as this will guide them to report more reliable information and involve less earnings management. Application of similar accounting standards for company's financial reporting ensures comparability of the information as a basic form of economic judgment. Moreover, harmonization of accounting standards is required to solve the issue of the different sets of incoherent financial statements which is followed by local standards over the world (Nobes & Parker, 2008). The main reason for adopting IFRS as a single set of standard is to ensure uniformity in accounting rules and regulation. This in turn is capable to produce more trustworthy and simplified financial statements which have higher value to the users in terms of the quality of accounting information. As comparability of financial statements are increased, managers are inclined to engage in less earnings management (Jeanjean & Stolowy, 2008). Comparability across companies and across countries could improve after the adoption of IFRS if investors, financial analysts, auditors, regulators and other stakeholders no longer need to understand financial statements that are prepared using different accounting standards from many

jurisdictions, thereby reducing information processing costs (Cox, 2007; Nijam & Athambawa, 2016).

Over the time empirical evidence on IFRS adoption has become the focus in the accounting literature. Especially, studies on the issue of IFRS accomplishment and the effect of IFRS adoption due to its nature of internationalization (Ashbaugh & Pincus, 2001; Barth, Landsman, & Lang, 2008; Nijam & Athambawa, 2016). If IFRS are of higher quality than prior reporting standards (Ashbaugh & Pincus, 2001; Barth et al., 2008), then their adoption should reduce information asymmetries. Two mechanisms by which IFRS are expected to reduce information asymmetries are increased disclosures of financial information, and enhanced comparability of cross border financial information prepared using a common set of standards (Daske, Hail, Leuz, & Verdi, 2008; Li, 2010). A cross country study of European public firms under the framework of IFRS and local GAAP by Aussenegg, Inwinkl, and Schneider (2008) reveals that the firms' reporting under IFRS framework are less involve in earnings management compared to the firms' reporting under local GAAP. IFRS requires a higher level of disclosure in financial reporting relative to most national accounting standards (Ashbaugh & Pincus, 2001; Ding, Hope, Jeanjean, & Stolowy, 2007), an increased level of disclosure is linked to increased accounting quality and decreased information asymmetry between controlling shareholders and outside capital suppliers (Biddle & Hilary, 2006). Moreover, IFRS adoption reduces information asymmetry and earnings management under higher audit quality. The role of audit quality is also an important factor that can influence relationship between IFRS adoption and earnings management (El-Guindy & Keasey, 2010); (Affes H & Smii T, 2016; Hanwen Chen, Chen, Lobo, & Wang, 2011; Houqe, Ahmed, & Zijl, 2017). Following the adoption of IFRS, improved financial reporting environment could increase the effectiveness of oversight and discipline that international financial intermediaries provide to market. In addition, it will reduce the opportunity for controlling shareholders to expropriate returns from outside

capital suppliers by undertaking value-destroying investment projects.

LITERATURE REVIEW

International Financial Reporting Standards (IFRS)

International Financial Reporting Standard is the principle based accounting standards which is issued by an UK stand independent organization, named International Accounting Standard Board (IASB). International Accounting Standard Committee (IASC) is the predecessor of the IASB, established in 1973 who are responsible for issuing international accounting standard (IAS) before IASB. IASB has developed a conceptual framework with few basic principles to guide the development of new IFRS and revision of the existing one. This conceptual framework addresses the purpose of the financial reporting, the characteristics of the elements of the financial statements as well as the quality of information. Financial reporting is intended to provide quality information to the user about the financial positions, claims and changes of a reporting entity. ("Deloitte: IAS Plus," September 6, 2016). The main player of IAS/IFRS adoption in Bangladesh are Government of Bangladesh (GoB), the World Bank (WB), Asian Development Bank (ADB) and the Institute of Chartered Accountants of Bangladesh (ICAB). It was initiated in 1999 after receiving a grant from the World Bank (WB) with the intention to develop accounting standards in Bangladesh (Zaman Mir & Shiraz Rahaman, 2005). The Institute of Chartered Accountants of Bangladesh (ICAB), is the main organization of the country, that have contributed significantly to the development of accounting profession in Bangladesh. Moreover, this institute is working continuously for the enhancement of accounting standards and the adoption of IFRS. ICAB has adopted all 29 valid IAS as Bangladesh Accounting Standards (BAS), where most recent adoption is IAS 29 on Hyperinflation which was effective from 1st January 2015. At the same time, 12 out of 13 IFRS issued by IASB were adopted by ICAB as Bangladesh Financial Reporting Standards (BFRS).

Earnings Management

To study the pattern of earnings management or the practice of the managers regarding earnings manipulation through accrual management or real activities. It is essential to know, why earnings is so important? In accounting information, earnings is presented in the financial statements and this information has dual role : informative and stewardship (Christensen, Feltham, & Şabac, 2005; Feltham, Indjejikian, & Nanda, 2006; Ronen & Yaari, 2008; Yasser, Mamun, Chapple, & Chapple, 2016). Here, stewardship is present due to the separation between owners and management in public firms where managers act as a stewards to the shareholders. However, the goal congruence between these two groups are feasible only if, accounting information helps shareholder to monitor the outcome of managers decision and provide incentives for aligning their interest. In this aspect, Watts and Zimmerman (1978) remarks that the purpose of financial reporting is to restrain management to act on behalf of their own interest. In general earnings management is an unwanted phenomena but in accounting practices it may not be always true. Arya, Glover, and Sunder (2003) state that, "Accounting research shows that income manipulation is not an unmitigated evil; within limits, it promotes efficient decisions". Moreover, Ronen and Yaari (2008) also suggest that all earnings management are not bad or deter the quality of accounting information. They also characterize earnings management as a set of managerial decisions to manipulate accounting numbers by hiding the true short terms financial performance to increase firm's value. They explain that earnings management practices can take in three forms, which are: i) beneficial (signal long term value), ii) pernicious (hide short or long term value) and iii) neutral (reveals the short term truth).

IFRS adoption and Earnings Management

It is commonly expected that the adoption of IFRS can contribute greatly to reduce earnings management by offering better financial reporting quality in the name of comparability and transparency (Barth et al., 2008; Gordon, Jorgensen, and Linthicum (2011)). Several studies

have examined the effect of switching from native accounting standards to International Financial Reporting Standards on the quality of accounting information reported in the financial statements. Cai, Rahman, and Courtenay (2008) investigated companies of 32 countries over the period of 2000-06 and identified significant reduction of earnings management in the countries where IFRS has been adopted. They also mentioned that the country's specific institutional factors such as monetary market, structure of the capital market, composition of firm's ownership and tax system, may play a role in the outcomes. It is also being observed that the firms adopting IFRS are engaged in lower earnings manipulation and produce better financial report (Barth et al., 2008). Another study by Chan, Hsu, and Lee (2013) describes that the transparency and credibility of foreign firms listed in the U.S.A. have increased following the adoption of IFRS. Moreover, Huifa Chen, Tang, Jiang, and Lin (2010) found that the quality of accounting information in terms of performance management, the extent of discretionary accruals and the quality of accruals, have improved after the adoption of IFRS. In contrast, Jeanjean and Stolowy (2008) conclude that the adoption of IFRS may not be able to reduce earnings management significantly which is also supported by the study of Van Tendeloo and Vanstraelen (2005) as well as Callao and Jarne (2010). However, other studies indicates that the adoption of IFRS offer greater transparency and comparability which results in strict accounting standards compared to local standards, induce managers to trade off between accruals management and real activities management (Cohen & Zarowin, 2007; Graham, Harvey, & Rajgopal, 2005).

Audit Quality and Earnings Management

The quality of external auditor is an essential mechanism to control the opportunistic behavior of the managers. The audit quality is highly dependent on the competency and independence of the external auditors which may be related to the magnitude of the audit firm (Bouchareb, Ajina, & Soud, 2014). Thus the size or magnitude of the audit firm (Big4 audit firm) is an imperative determinant of the audit quality. Prior study shows

that the large audit firm (earlier Big8, now Big4) ensures high quality audit of the financial statements and reduce earnings management through discretionary accruals (Craswell, Francis, & Taylor, 1995; DeAngelo, 1981). The intensity of earnings management is reduced by superior audit quality (big4 audit firm) and it also restrain managers from opportunistic behavior (Krishnan, 2003; S. Lin, Radhakrishnan, & Su, 2006). However, in few studies researchers identified that there is no association between audit quality and the level of earnings management, which means that Big4 audit firm affiliation as an alternative of audit quality may not be able to influence the earnings management behavior (Davidson, Goodwin-Stewart, & Kent, 2005; Memis & Cetenak, 2012; Xu, 2014; Yasar, 2013). In Bangladesh, Humayun Kabir, Sharma, Islam, and Salat (2011) reported that the relationship between audit quality (Big4 audit firm) and accruals quality highly depends on the measure of audit quality and the model used for accruals estimation. They also highlighted that the Big4 audit firms affiliation in Bangladesh does not have any positive impact on accruals quality. Recent studies documented that the audit quality (audited by Big4) can play a vital role to restrain the managers from earnings management through discretionary accruals under IFRS framework (El-Guindy & Keasey, 2010; Francis & Wang, 2008; J. W. Lin & Hwang, 2010).

Moderating role of audit quality on IFRS adoption and Earnings Management

The role of auditor is to investigate the financial statements of the company which is prepared by the management, for identifying possible material misstatements. If any material misstatement is discovered, auditor may ask management to adjust it or otherwise report it, as it is expected to be a determinant of earnings quality (Becker, DeFond, Jiambalvo, & Subramanyam, 1998; DeAngelo, 1981). An auditor's effort and effectiveness depends on the ability to detect financial statements error or misstatement which may be influenced by different external factors, such as goodwill of the firm, independent practice of the auditor and risk for litigation (Nelson, Elliott, & Tarpley, 2002).

Reputation hypothesis posits that big or reputable audit firms are not likely to engage in low quality audit because of their reputation concern to the clients (DeAngelo, 1981). Earlier studies also suggest that the big audit firms are capable to produce more reliable information for the investors which ensures higher audit quality (Becker et al., 1998; El-Guindy & Keasey, 2010; Francis & Wang, 2008). Moreover, earnings management practices are influenced by the financial reporting standards and their execution (El-Guindy & Keasey, 2010; Van Tendeloo & Vanstraelen, 2005). A recent study by El-Guindy and Keasey (2010) documented that the audit quality plays a key role under IFRS framework i.e. firm audited by big4 audit firms having significant influence on financial reporting. Accordingly, the association between IFRS adoption and earnings management may be influenced by the role of audit quality in terms of big4 audit firms.

The proposition of this study is to examine how a company response to the changes in international accounting practices and what are the post implementation effect of IFRS on financial reporting quality in terms of earnings management. In addition, the study focuses on the effect of audit quality on the relationship between IFRS adoption and earnings management. The proposed objectives of the study are: To identify the effect of IFRS adoption on earnings management by considering discretionary accruals as proxy; To examine the influence of audit quality on the level of earnings management; To investigate the role of audit quality on the relationship between IFRS adoption and earnings management.

METHODS

Proposition

The main purpose of the research is to explain how transformation to a unique global accounting standard (IFRS) can change the financial reporting quality of the company which is measured in terms of earnings management. This study investigate the effect of IFRS adoption on earnings management practices and also with the influence of audit quality (big4 audit firm) on

earnings management. It is a noteworthy question for the user of financial statements, whether the mandatory adoption of IFRS in Bangladesh is successful to provide higher accounting quality, including a lower level of earnings management. The theoretical framework of this study is presented in figure 1 with clear identification of independent, dependent and moderating variables.

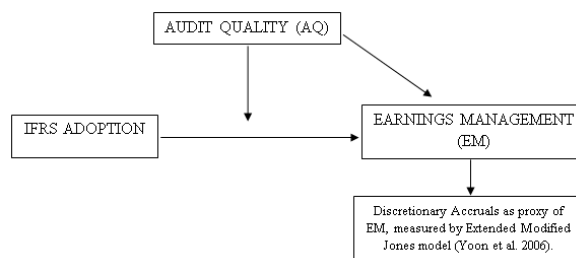


Figure 1. Study Framework

Based on earlier discussion, this study develops three propositions:

Proposition 1: The adoption of IFRS tends to lower the level of earnings management in Bangladesh.

Proposition 2: Audit quality is negatively associated with the level of earnings management.

Proposition 3: Audit quality moderates the relationship between IFRS adoption and earnings management.

METHOD

This study synthesizes the effect of IFRS adoption on financial reporting quality in terms of earnings management in Bangladesh, the effect of audit quality on earnings management, and also the moderating influence of audit quality on the relationship between IFRS adoption and earnings management. The outcome of this research will give an overview of unique sets of global accounting standard and their effects on the financial reporting quality of companies in developing economy like Bangladesh. Recent studies documented that the extended modified Jones model (Yoon, Miller, & Jiraporn, 2006) is more effective for accrual estimation than the modified Jones model (Dechow, Sloan, & Sweeney, 1995) in developing country (Alareeni & Aljuaidi, 2014; M. T. Hasan & Rahman, 2017; Hoang, 2014; Islam, 2014). This study examines two time period:

2004-06 as the pre adoption and 2013-15 as the post adoption of IFRS, in total 6 years. All listed firms of Dhaka Stock Exchange (DSE) are included except for financial and government owned companies due to their nature of operation and control by regulatory bodies.

Accruals Model for Earnings Management Detection

Earlier studies suggested that the modified Jones model (Dechow et al., 1995) is effective to estimate discretionary accruals more precisely compared to other models (Dechow et al., 1995; M.

T. Hasan & Rahman, 2017; Islam, Ali, & Ahmad, 2011; Yoon et al., 2006). However, The study of Yoon and Miller (2002b) provided that the modified Jones model does not fit well for Korean firms as well as Asian firms. Accordingly, Yoon et al. (2006) proposed an extended version of modified Jones model for better estimation of the discretionary accruals, known as extended modified Jones model. Specification of the proposed model is represented in table 1 with the explanation of the related variables.

Table 1. Extend Modified Jones Model for Accruals Estimation

$$TA_i/REV_i = \beta_0 + \frac{\beta_1(\Delta REV_i - \Delta REC_i)}{REV_i} + \frac{\beta_2(\Delta EXP_i - \Delta PAY_i)}{REV_i} + \frac{\beta_3(DEP_i + PEN_i)}{REV_i} + \varepsilon_i \quad (1)$$

Where,

TA (Total accruals) = accounting earnings – Cash Flow from Operation (CFO)

REV = Net sales revenue in period t

ΔREV = changes in net sales revenue

ΔREC = changes in trade receivables

ΔEXP = changes in sum of cost of goods sold and selling & general administrative expenses excluding non-cash expenses.

ΔPAY = changes in trade payables

DEP = depreciation expenses

PEN = retirement benefits expenses

Δ = change operator

$$DA_i = (TA_i/REV_i) - [b_0 + \frac{b_1(\Delta REV_i - \Delta REC_i)}{REV_i} + \frac{b_2(\Delta EXP_i - \Delta PAY_i)}{REV_i} + \frac{b_3(DEP_i + PEN_i)}{REV_i}] \quad (2)$$

Here, b_k represents the estimated coefficients of β_k in equation (1). The discretionary accruals (DA) obtained from the equation (2) represent the differences between actual total accruals and the expected (non-discretionary) total accruals.

This model explains that the total accruals normally depends on the changes in cash sales revenue (ΔREV) which is derived from the adjustment of the changes in revenue with the changes in receivables, changes in cash expenses (ΔEXP) which is resulted from the adjustment of the changes in expenses with the changes in payables, and non-cash expenses counting depreciation expenses (DEP) and retirement benefits expenses (RBE). Discretionary accruals is determined after adjusting non-discretionary accruals with total accruals derived from the

adjustment of accounting income with cash flow from operation. This study will considers the extend modified Jones model (Yoon et al., 2006) to estimate the discretionary accruals as the proxy of earnings management.

Sample and Variable Design

This study proposed to consider all listed firms other than financial and regulatory company due to their nature of operation and close supervision by the authority, in Dhaka Stock Exchange, Bangladesh (Callao, Jarne, & Láñez,

2007; Nouri & Abaoub, 2014). The data will be collected for two time frame for 2006-08 as before adoption period of IFRS and 2013-15 as post adoption period of IFRS. Time frame of 2009-12 will be excluded due to the implementation phase of IFRS in Bangladesh and demutualization of listing share in DSE. Beside these, in 2009-10 Bangladesh capital market has suffered a significant setback due to financial scandal (M. S. Hasan, Hossain, & Rahman, 2014). Thereafter, few companies are excluded due to non availability for both time periods and few for non-availability of the information or annual report. The final sample consists of 102 firms which are listed in DSE for both time periods. Accordingly, the study covers $(102 \times 6) = 612$ firm years observation to explore the hypothesis.

DISCUSSION

The main focus of the study is to identify the effect of certain variables, namely IFRS adoption and audit quality on earnings management behavior of the company. Previous studies have examined the effect of selected variables on earnings management. However, results from previous studies have inconclusive findings which suggest that it is thoughtful to investigate the effect of IFRS implementation in emerging economy (Brüggemann, Hitz, & Sellhorn, 2013) and provide a potential basis for the assessment of the extent to which the objectives of IFRS adoption has been met. This study expects to explore the effect of IFRS adoption on earnings management as well as the influence of audit quality in terms of big4 on the relationship of IFRS adoption and earnings management. Outcome of this study may helps regulatory body of Bangladesh to work for greater safety of capital market investors following the worst ever crash on 2009-10. It is expected that the outcome of this study will contribute to the accounting literature by studying the effect of IFRS adoption and audit quality on earnings management in an emerging economy like Bangladesh.

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