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The IFRS Adoption and Accounting Quality: A Comprehensive Trend Analysis

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Abstract

In this study, we explore the impact of International Financial Reporting Standards' adoption on accounting quality in Turkey over years as a candidate state to European Union. We examine the financial statements of the 19 largest companies listed in Borsa Istanbul using accounting quality metrics and trend analysis. We find significant evidence that the implementation of International Financial Reporting Standards helps to improve accounting quality over years in Turkey.

Keywords: IFRS, Accounting Quality, Trend Analysis, Market Value

Introduction

Because of financial information manipulation, the real financial positions and operating results of firms cannot be reflected onto the financial information users. This on one hand causes the investors who invest in the securities of these firms to incur losses and lose confidence in the system, and on the other hand causes resources (funds) allocated to wrong and inefficient fields because of investment decisions in the firms and buying and selling decisions of investors about securities. As a result, additional costs are brought to the economy (Küçükkocaoğlu & Küçüksözen, 2005).

When manipulation is in question, generally and normally most of the people think that firms decrease their incomes and increase their expenditures in order to pay less tax. However, the exact opposite of this is performed in order to achieve firm value (stock price) maximization which we briefly mentioned above. While firms apply earnings management, they choose to increase their incomes (for example making consignment sales look like normal sales) and decrease their expenditures (for example making sales and marketing expenditures look like research and development expenditures) by using accruals generally in the legislative framework. That is why, the results of a lot of studies reveal that firms increase their incomes by certain motives and incentives, and therefore implement earnings management.

The frequency of the academic studies in recent years regarding the consistency of accounting figures and financial information manipulation has shown the necessity of these studies especially after Enron, WorldCom and Parmalat corporate scandals (Penman, 2003). At the heart of these studies – which find a far-reaching place especially in the Anglo-Saxon literature

– the extent to which financial statements reflect the truth is observed (Küçükkocaoğlu & Küçüksözen, 2005).

In summary, the considerations set out above would call for financial reporting of high quality and less subjectivity. Higher accounting quality in financial reporting would be accompanied by higher conservatism and less information asymmetry (Ball & Shivakumar, 2005). Providing true trustful information through financial statements is deemed as accounting quality. In other words, if the financial statements are prepared for the favor or anticipation of any of user, true information is hidden through legal or illegal methods or wrong information is inserted, then financial information manipulation has been done which is not possible to mention about accounting quality.

Some scholars believe that there is a need for clear, understandable and comparable financial reports a common international accounting standard. This common accounting system will help to reduce cost of capital through minimizing information asymmetries and increasing the capital flow between countries. In contrast, some scholars stress that content and type of the accounting standards is defined by local business environment and local market characteristics. According to them, it is not necessary to use same accounting standards in different countries and it is uncertain that IFRS has positive impact on accounting quality (Chen, Tang, Jiang, & Lin, 2010). However, integration of the capital and money markets, globalization, the developments in the international trade requires synchronization in recording and unity in accounting standards (İlker, 2010). The countries and the firms who do not want to be deprive of global capital adopt IFRS or synchronize their local standards with IFRS.

IFRS restricts and lessens alternative accounting options. Thus, it limits the use manipulation methods such as earning and income smoothing. Furthermore, uncertainty and inconsistency in the application of local standards can be eliminated through IFRS which is easy to interpret and adopt. Another advantage of the IFRS adoption is that it helps international investors in understanding, analyzing and making decision. This advantage encourages and force managers to prepare financial reports free of manipulation. One common accounting system also facilitates auditing. (Chen et al., 2010). Ashbaugh (2001) suggested that communicating with investors was an important motivation for the use of international standards. International firms may want to communicate financial information to interested parties, and may select IAS to increase transparency in reporting and reduce restatement of financial information (Tarca, 2004).
Chen et al. (2010) find accounting quality has marginally improved after IFRS in sample EU firms and countries. This result suggest that IFRS limit management opportunistic discretions by reducing available accounting alternatives. By a higher quality standards reduces managerial discretion over accounting choices or inherently disallows smoothing or overstatement of earnings. If IFRS are of higher quality than domestic GAAP, and they are appropriately enforced, then would be expected mandatory adoption of IFRS to improve accounting quality. On the other hand, if IFRS are of lower quality than domestic GAAP or if they weaken enforcement (for example because of increased discretion or flexibility), then we would expect them to reduce accounting quality. Thus, the impact of IFRS on accounting quality is an empirical question (Ahmed, Neel, & Wang, 2013).

Accounting quality could also increase because of changes in the financial reporting system contemporaneous with firms' adoption of IAS, for example, more rigorous enforcement (Barth et al., 2008). To develop a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. The adoption of IFRS around the world is occurring rapidly under the assumption that there will be benefits from having a uniform set of standards for financial reporting around the world so that cross-country comparisons of firms are easier and more transparent (Holthausen, 2009).

It is possible that investors in European firms would react positively to movement toward IFRS adoption if, for example, investors expected application of IFRS to result in higher quality financial reporting information, thereby lowering information asymmetry between the firm and investors and information risk and, thus, cost of capital. Investors also might have believed that application of a common set of standards would have convergence benefits, such as lowering the costs of comparing firms' financial position and performance across countries (Armstrong, Barth, Jagolinzer, & Riedl, 2010).

Mostly, local and international investors are guided by investment analysts who predict and interpret the future movements. It is very crucial for Analysts to understand and interpret the financial reports of the firms which they analyze in order to minimize errors in their prediction of future earnings. IFRS provides more accurate information to investment analysts. Ashbaugh and Pincus (2001) show that analyst forecast accuracy improves after firms adopt IAS. More specifically, after controlling for changes in the market value of equity, changes in analyst following, and changes in the number of news reports, the convergence in firms' accounting policies brought about by adopting IAS is positively associated with the reduction in analyst forecast errors.

IFRS may decrease the quality of accounting because there might be limiting managerial discretion relating to accounting alternatives could eliminate the firm's ability to report accounting measurements that are more reflective of its economic position and performance (Barth et al., 2008). In addition, the inherent flexibility in principles-based standards could provide greater opportunity for firms to manage earnings, thereby decreasing accounting quality. A further reason IFRS may lower accounting quality is because certain accounting treatments under IFRS inherently result in more income smoothing and/or overstatement of earnings than domestic GAAP. For example, IFRS permits capitalization of development expenditures. This is likely to result in both smoother and higher income (Ahmed et al., 2013).

This study employs comprehensive trend analyses different from previous researches in measuring accounting quality with the implementation of IFRS.

Data and Methodology

Our data set includes quarterly observations from 19 largest companies listed in Borsa Istanbul. It consists of 133 observations spans from 2005 to 2011 obtained from Borsa Istanbul. Information on the balance sheets, cash flow statements and income statements of the selected companies are used to produce following variables to be used in the study.

Test Variables
Δni : percentage changes in net income
Δcf : percentage changes in net cash flow from operating activities
size : the natural logarithm of total market value
growth : percentage changes in net sales
eissue : percentage change in common stock
dissue : percentage change in total liabilities
lev : the ratio of end-of-year total liabilities to end-of-year book value
turn : the ratio of Net sales to end-of-year total assets
cf : the ratio of annual net cash flow from operating activities to end-of-year total assets;

Panel data, also called longitudinal data or cross-sectional time series data, are data where same entities (panels) like people, firms, and countries were observed at multiple time points. A panel data set yield more efficient estimators than a series of cross-sections with the same number of observations if the goal is to measure the effects of exogenous variables included in the model (Nijman & Verbeek, 1990).

Panel data reduces identification problem resulted from measurement error, endogenous repressors, omitted variables (Hsiao, 1985). Panel data allows identification of certain parameters without the need to make restrictive assumptions. It is employed to model why individual units behave differently at different time horizons. This study conducts panel data and panel regression estimation method for the following equation;

$$size_i = c + \beta_1 \Delta cf_i + \beta_2 \Delta ni_i + \beta_3 cf_i + \beta_4 eissue_i + \beta_5 dissue_i + \beta_6 growth_i + \beta_7 lev_i + \beta_8 turn_i + e_i$$

Where c is the constant term and e_i is the error term.
In the following equation;
$y_{it} = \omega_i + \beta x_{it} + e_{it}$

Empirical Results
In the final stage of the analysis, the multivariate regression model is employed to investigate trend and changes in the relationship over time answering which factors have contributed to market price of the over years after implementing IFRS. In fact in doing this it is possible to gauge out the role of IFRS implementation on the accounting quality in Turkey over years. Besides, it is logical to assume that the implementation of IFRS does not impact accounting quality suddenly. The positive result could be observed over years gradually. The result indicated in Table 1 shows that the ratio of annual net cash flow from operating activities to end-of-year total assets has significant and permanent impact over years which are a very good indicator of accounting quality. The impact of percentage change in total liabilities disappears after 3 years of implementation. Also, the impact of the ratio of net sales to end-of-year total assets and the percentage change in common stock are detected as good indicator of accounting quality.

Table 1
Eviews Result Table for Trend Analysis

Dependent Variable LOGSIZE
Method: Panel Least Squares
Periods included: 7
Cross-sections included: 19
Total panel (balanced) observations: 133

	2005	2006	2007	2008	2009	2010	2011
DCF	0.00000000291	0.00	0.00	0.00	0.00	0.00	0.00
	5.422835	*2.455858*	*0.187519*	*-2.210831*	*2.105373*	*-2.308166*	*-3.228249*
DNI	-0.00000000136	0.00	0.00	0.00	0.00	0.00	0.00
	-2.536727	*1.194124*	*7.000796*	*-3.089612*	*-0.301067*	*2.269077*	*-1.031056*
CF	**1.187522**	**1.99217**	**0.697642**	**1.931685**	**0.970191**	**2.487803**	**1.866206**
	3.131069	*5.246233*	*2.237554*	*5.895813*	*2.800271*	*6.107293*	*6.087637*
DISSUE	**0.001079**	**0.003059**	0.000511	**0.001976**	0.001965	-0.00021	-0.000004
	1.972006	*3.220888*	*0.995435*	*2.654264*	*1.211269*	*-0.426986*	*-0.134246*
EISSUE	-0.0000125	-0.000472	**0.001564**	0.00018	**0.002546**	0.00031	-0.000105
	-0.058798	*-0.929919*	*2.584379*	*1.819681*	*2.700121*	*1.185563*	*-0.327579*
GROWTH	0.000731	0.000731	-0.000049	0.000731	0.002159	0.000554	-0.000006
	0.575206	*0.950603*	*-0.468191*	*1.787851*	*1.439048*	*0.685376*	*-0.300241*
LEV	-0.005647	-0.001806	0.017323	0.006154	-0.017311	**0.005086**	0.003398
	-1.452315	*-0.628204*	*0.831563*	*0.552078*	*-0.789411*	*2.398745*	*0.283519*
TURN	0.020007	0.061382	**-0.006738**	**-0.011116**	**-0.013572**	**-0.011864**	0.026873
	0.469608	*1.349115*	*-2.638464*	*-2.196695*	*-2.59932*	*-2.317991*	*0.37215*
C	7.975177	7.877537	8.051017	7.721209	8.135341	8.252972	8.252674
	111.5704	98.84999	135.3385	127.6191	126.7488	155.1164	97.38187
Adj. R2	0.223935	0.251651	0.263607	0.197695	0.117542	0.210766	0.157094
F-statistic	7.925259	9.238724	9.904529	7.314243	4.379896	7.809829	5.752501
Durbin-Wats	2.267331	2.005585	2.123426	2.038849	2.026787	2.058969	2.085399

Conclusion

It is very crucial for local and International investors, policy makers, managers, and analysts to have correct information about the financial position of the firms in order to make a robust prediction of firms' real values and their future earnings. IFRS is believed to be superior in providing more accurate information to those demander and users of the financial reports over IAS. In order to test this argument, this study examines the impact of IFRS implementation in Accounting Quality in Turkey.

The empirical result indicates accounting quality is poor in the whole sample of IFRS implementation. Higher level of liabilities have significant role in defining the firms' market value which might be problematic due to fact that using liabilities has potential source for mitigating role of accounting quality. As for trend analysis, it can be inferred that the accounting quality is improving with the implementation of the IFRS in Turkey over the sample period. Trend analysis has superior over the other methods in the literature. It can capture the direction and power of the impact over years which is not possible to observe through whole sample analysis.
Policy makers, investors, auditors and managers as demanders of the unfalsified financial reports might have beneficial implications from the finding of this research. It is highly recommended that IFRS adoption should be generalized to all firms to attain good level of accounting quality and to avoid detrimental effects of asymmetric information to the whole economy.

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