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The influence of IFRS adoption on earnings management: a cross-country analysis

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The Influence of IFRS Adoption on Earnings Management: A Cross- Country Analysis

By

Kayode Richard Abeleje

(PhD)

January, 2019



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January, 2019



*A thesis submitted in partial fulfilment of the University's
requirements for the Degree of Doctor of Philosophy.*

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Project Title:

**The Influence of IFRS Adoption on Earnings Management: A
Cross-Country Analysis**

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Abstract

This research evaluates the global impact of the International Financial Reporting Standard (IFRS) in promoting the quality of reported earnings with a focus on earnings management. The purpose is to seek an answer to the question: Can the IFRS be a 'one size fits all' standard? The European Union, with the support of the International Accounting Standards Board (IASB), initiated the IFRS. However, this was challenged by the force of globalisation. Contrary to how and why the IFRS originated, over 120 countries, mostly non-EU countries and of emerging economic status, have subscribed to the IFRS since it was made mandatory in 2005. The flexibility resulting from IASB trying to accommodate more countries has led to opportunistic earnings management (EM) by managers. Although IFRS is popular with its comprehensiveness, ability to reduce information asymmetry, promotion of cross-border transactions, easy comparability of financial statements among countries and possibility of raising funds in the international capital market, this thesis agitates that its efficacy in promoting the quality of published financial statements is dependent on the viability of the enforcement mechanisms in its application. Also, this research admits the universality of earnings management and increased adoption of IFRS as provoked by globalisation. It, however, argues that the level of economic, political and human development differs among countries. This might serve as an impediment for the usefulness of the standard in enhancing the quality of reported earnings. Hence, considering institutional diversities of countries, this thesis evaluates the relevance of the uniform standard to the reliability of published financial statements. Adopting purposive sampling and the Modified Jones Model, public listed companies in five developed economies (UK, France, Australia, Germany and Italy) and five emerging economies (China, South Africa, India, Malaysia and Brazil) were comparatively evaluated. The financial statements of firms of the selected countries were analysed over a period of 21 years, to include the 10-year pre-adoption and 10-year post-adoption criterion. Discretionary accrual was used as the proxy for earnings management while the variability of net income and variability of cash flow from operation were also used as robustness checks. As a contribution to knowledge, the research uniquely captures country related variables such as the governance indicator (GOVind), average growth rate in GDP, the human development index (HDI) and the economic status of countries in the OLS regression models used. The models test the efficacy of the IFRS in curbing earnings management. The result reveals that IFRS is effective in reducing earnings management. However, more enforcement is needed on the application of the standard among emerging economies than in developed economies. Hence, IFRS thrives well where the enforcement infrastructure is strong. Therefore, consistent with the contingency theory, this thesis finds that the IFRS is a good standard.

However, its efficacy is sensitive to the economic conditions and human development level of the country in which it is applied. Consequently, although the IFRS may be said to be a uniform standard across the globe, it may not have the same impact across the globe due to the economic, political and human development of countries. Emerging economies should adapt the standard to their settings rather than undertaking wholesale adoption. The results have implications for international organisations that are championing the adoption of uniform accounting standards across the world. Economic conditions and human development levels of individual countries should be determined to know which part of the IFRS will be adopted to achieve the intended benefits of adoption.

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Chapter One: Introduction

1.1 Background to the Study

The advent of globalisation came with the force of change influencing the way and manner all professions including accountancy are practised. The profession of accountancy has not seen a significant change such as it witnessed in the last decade (Lourenco and Branco, 2015). The bid to devise a common language on the premise of which countries across the globe report their financial activities to the users of financial statements have attracted endless debates in academia. Therefore, the International Financial Reporting Standard (thereafter IFRS) came as a welcome innovation in the field of accountancy and with high expectations, but not without inherent challenges. Its impact has been controversial and an issue of debate most especially in both the academia and the financial press.

In response to the waves of financial scandals that emanated from the global capital market between 2000 and 2001, the International Accounting Standards Board (thereafter IASB) perceived the need to boost investors' confidence by instituting more rigorous regulations. This was what led to the IFRS (Sellami and Fakhfakh, 2014). However, Capkun *et al.* (2012) argue that the IFRS came as an initiative of the European Union (EU) in 1973 to have a more competitive stand with the USA in the global capital market. The motive was to achieve a strategic advantage by devising a uniform and reliable financial reporting system among member countries. This uniform standard could then attract global investors who rely on transparent accounting information in making their investment decisions. Hence, the first version beneficiaries of the IFRS were EU member countries.

Subsequently, the IFRS gained the backing of various international organisations such as the World Bank (WB), International Monetary Fund (IMF), International Organisation of Securities Commission and

the International Federation of Accountants (IFAC). In line with this, the WB and the IMF inaugurated a program to educate their member countries on the importance of adopting international accounting and auditing standards. The International Organisation of Securities Commission wants adoption of IFRS to enhance smooth cross-border transactions and to sustain the stability of the capital market (Ali, 2005). Likewise, the IFAC also advised its member countries to be IFRS compliant in their various jurisdictions (Ali, 2005).

The relevance of the IAS/IFRS adoption to emerging economies has received increasing research attention by scholars¹. Some authors argue that sound financial reporting system should suit the settings of its application (Tweedie and Seidenstein, 2005). However, the impact of institutional and environmental factors on the operationalisation of accounting standards is least researched; particularly, in the context of emerging economies. According to Othman and Kossentini (2015) adopting an external accounting system such as the IFRS might be unsuitable, irrelevant and might be harmful to adopting countries, especially emerging economies.

The reason might be traced to the fact that the initial intention of devising the standard does not incorporate emerging economies (Capkun *et al.*, 2012). However, other authors argue that the adoption of a high-quality accounting standard, IFRS, by emerging economies will improve the quality of their financial reporting system. The improved financial reporting system will attract foreign direct Investment (FDI) and will ultimately impact on the economic development of the country. In addition to this, adopting countries are better positioned with international economic organisations such as the

¹ For instance, the research of Larson and Kenny (1993) on African developing countries; Assenso-Okofu *et al.* (2011) on Ghana; Mashayekhi and Mashayekhi (2008) on Iran. Also, Al-Akra *et al.* (2009) study on Jordan, Mir and Rahman, and (2005) on Bangladesh; Ashraf and Ghani (2005) on Pakistan; and Tyrrall *et al.* (2007) on Kazakhstan explored issues in IFRS adoption in emerging economies.

World Bank regarding financial aid and other economic support (Nnadi and Soobaroyen, 2015).

Based on this premise, this thesis evaluates the quality of published financial statements among countries given their economic status, institutional features and human development indices. Generally, it assesses the notion that IFRS might not be ‘a one size fits all’ standard for all countries. This is to challenge the on-going adoption campaign and to examine the relevance of convergence or adaptation of the standards. This is especially pertinent to the emerging economies due to how IFRS originated and the original purpose of its creation.

1.2 Motivation for the study

Given the level of economic development, institutional structure and human development of member countries, it worth finding out how the standards fit into emerging economies based on these criteria. Also, the literature established the positive impact played by the Big Four² regarding IFRS adoption. However, all the Big Four have their headquarters in developed economies that happened to be early adopters of the IFRS (apart from the USA, which is the headquarters of Deloitte). Contrary to how and why IFRS originated, countries - which are mostly non-EU countries - have subscribed to IFRS since 2005, the mandatory adoption year. This includes most emerging economies whose economic status and preparedness do not match up to that of developed countries. A statement from the IFRS’ website corroborates this:

² The Big Four audit firms include Deloitte, PWC, EY and KPMG. It was formerly known as the Big Eight; later the Big Six and then Big Five due to mergers. The Enron Scandal led to the demise of Arthur Anderson in 2002. This led to the emergence of the Big Four.

“---While the European Union is the single biggest part of the IFRS usage base, the non-EU/EEA jurisdictions that use IFRS Standards also are a large component of the IFRS users”.

The fundamental belief of the IASB is that the high-quality standard is a vital pre-requisite to high-quality financial reporting. The uniformity of the standard would further help global investors and other users of financial statements in making informed economic decisions. Therefore, it is worthwhile to consider how financial reports prepared based on a high-quality standard (IFRS) portray the actual economic realities of the reporting entities. In other words, investors would like to place reliance on financial statements that are devoid of earnings management³ and reliable enough for informed decisions.

In a bid to accommodate more countries despite their distinct economic, cultural, legal and political background, the original IAS (International Accounting Standard) metamorphoses into IFRS. This flexibility has been established to have encouraged earnings management (EM) (Capkun *et al.*, 2012). This has also resulted in academic debates on whether the IFRS has curbed earnings management or encouraged it (Jeanjean and Stolowy, 2008; Rudra and Bhattacharjee 2012; Capkun *et al.*, 2016).

Furthermore, the findings from prior studies of the impact of IFRS adoption on the quality of reported earnings are mixed and inconclusive. Also, most studies conducted are country-specific, some are solely on developed economies, few studies exist on emerging economies and most research used too few years in their analyses (Elbannan, 2011; Liu and Sun, 2015). In addition to this, the literature established that the degree of earnings management is strongly

³ For the purpose of this chapter, earnings management is defined as a strategy used by the management of a company to intentionally manipulate the company's earnings towards a pre-determined figure so as to influence the decisions of users placing reliance on it.

associated with weak accounting infrastructure (Godwin *et al.*, 2001; Hu *et al.*, 2017). This is a particular feature of the accounting system of emerging economies. Therefore, this study tests this notion and also evaluates the differential impact of IFRS adoption between the period of countries' GAAP (Generally Accepted Accounting Principles) and the IFRS era.

In other words, it examines how, after a decade, IFRS has achieved its purpose among the selected developed countries and the implications of this on the wholesale adoption mostly identified with countries of emerging economic status. This study sheds light on the global impact of the International Financial Reporting Standards in promoting financial reporting quality by comparatively assessing the experience of first-time adopting developed countries with countries of emerging economy status. Thus, the targeted study countries are divided into two broad categories: developed countries and emerging economies. At the end of this research, we should be able to appreciate if the expectation that the IFRS as a high-quality accounting standard will promote the credibility of financial reporting among countries has been realised or not.

1.3 Statement of the Problem

The International Accounting Standards (IAS) originated from Europe as a result of the moves by the European Commission between 1970 and 1999 to establish uniform accounting standards that would enhance comparable financial statements based on the formats, measurement and recording rules from which they are prepared (Capkun *et al.*, 2016). The Commission approached this by issuing directives. The directives that are most influential in the history of EU in their move towards financial statement convergence are the Fourth Directive (issued in 1978) and the Seventh Directive (issued in 1983). While the Fourth Directive emphasised the principle of true and fair view of financial

statements, the Seventh Directive focused on consolidation related issues (Capkun *et al.*, 2012).

However, contrary to the expectation of the European Union, the process of harmonisation was slow as the speed of conversion of the Directives to national laws by member states varied. For instance, the UK and Denmark had the Fourth Directive enacted into Law in 1981, whereas Austria did not comply until 1995. This made the EU change its strategies by proposing that adoption of IFRS be mandatory for all European-listed firms by 2005. The purpose of taking this giant step was the belief that adoption of high-quality accounting standards by European countries would give their firms reasonable grounds for accessing external capitals just as well as or, if possible, better than contemporary US firms.

In the same vein, the International Financial Reporting Standard (IFRS), which was initially labelled IAS, started from the same origin. Due to the dominant role this part of the world assumes in the global financial market, IFRS adoption has gained prominence among many countries. Currently, over 130 countries out 194 countries worldwide (67%) have subscribed to IFRS. Paradoxically, despite the influence of the USA on the global economy, it is yet to subscribe to IFRS. In addition to this, most countries, especially the emerging economies whose reporting system is strongly influenced by their local standards, seem to be at the obedient end. In order not to miss out on benefits accruable from IFRS, they adopt it despite their non-readiness.

Most research conducted on the impact of the international accounting standard on financial reporting quality is on specific countries⁴ while some incorporate only a few countries⁵. Leuz *et al.*, (2003) laid the

⁴ For instance, Sellami and Fakhfakh (2014) on France; Gunther (2011) on Germany; Liu *et al.* (2011) on China

⁵ See Zeghal *et al.* (2011), Jeanjean and Stolowy (2008)

foundation for a multi-country study of the impact of international accounting standards on the level of earnings management practices among countries. They classify the 31 countries studied based on their institutional features, which include the legal system, capital market strength, ownership structure and investors' protection. Their results reveal that insider-oriented economies' companies have the features of concentrated ownership structure, little or no investors' protection and under-developed capital markets. However, this research was conducted before 2005, when the high-quality standard IFRS became mandatory for all European Union countries.

Furthermore, the multi-country study of Doukakis (2014) on 22 countries incorporated both the years before and after the adoption of the IFRS. However, all the countries are entirely members of the European Union. Since more emerging economies are showing increasing interest in the standard, there is a need for a study that will substantiate and present fresh insights on whether the IFRS has positively impacted on financial reporting quality among countries that are not part of its origin. In line with Isomorphism theory, sustained positive impact might encourage more emerging economies to adopt the standard. Also, it provides an insight into the suitability of the standard in emerging economies. This is the central research gap this thesis intends to fill.

As argued by Haw *et al.*, (2004), countries with substantial investors' protection and effective enforcement systems have reduced earnings management compared to countries where these features are missing. They emphasised that undisclosed discretionary accruals are minimised in countries with good investors' protection and effective law enforcement systems. According to Leuz *et al.* (2002), investors' protection and effective enforcement systems are standard features of developed countries. The efficacy of the IFRS in enhancing financial reporting quality has been established to be highly dependent on these

factors (Houqe *et al.*, 2012; Zeghal *et al.*, 2012). On this basis, this thesis intends to study the influence of the adoption of IFRS on the financial reporting system of adopting countries considering their economic status and institutional features. This gives greater common ground for the generalisability of research results concerning each economic classification⁶ than where only institutional features are studied.

The institutional and environmental factors have also been identified to motivate the tendency of increased earnings management among privately and publicly owned firms (Gunther, 2011). Burgstahler *et al.* (2006) observe more earnings management with private firms than with public firms. Based on these institutional factors and their differences are observed to be highly motivating factors to the level of earnings smoothing in the countries investigated.

Evidence also exists in the literature about how the difference in the institutional environment could influence earnings management behaviour between public listed and privately-owned firms. According to them, privately owned firms practice more earnings management than publicly owned firms. On this premise, the institutional framework and its discrepancies are found to be the influencing factors affecting the degree of earnings management found among countries. Investor protection, book-tax configuration, capital market structure and firm ownership also have a strong influence on earnings management behaviour (Gunther, 2011). Leuz *et al.*, (2003) establish that insiders

⁶ The economic classification adopted in this thesis is based on the World Economic Situation and Prospects (WESP) (2014) of the United Nations' website. This study views developing economies as emerging economies. See http://www.un.org/en/development/desa/policy/wesp/wesp_current/2014wesp_country_classification.pdf. The list of countries studied was also confirmed with those on the World Bank's website. See <http://data.worldbank.org/about/country-classifications>.

tend to manage earnings to protect their controlling interest and guard against external interference.

Managers use accounting discretion in the boom period by understating earnings through the creation of hidden reserves that could be used in the gloom period to smooth earnings. Gunther (2011) draws an inference from this by concluding that ownership structure could be one of the critical factors of earnings characteristics in Germany and countries having a similar institutional framework.

1.4 Research Aim and Objectives

This thesis builds on prior studies and earlier debates on whether, after a decade, IFRS adoption has impacted positively on the quality of reported financial statements. Ball (2016) noted that "IFRS adoption is an innovation of historical proportions whose worldwide effects remain somewhat uncertain". Prior studies including fewer years, such as those of Daske *et al.* (2008), Li (2010) and Zeghal *et al.* (2012) suggest that further investigation is needed using a larger sample period to evaluate whether the effect of IFRS adoption is sustained in the long run or not.

Hence, for balanced comparison of pre-adoption and post-adoption effects of IFRS adoption on the quality of published financial statements, this research focused on active firms of selected developed countries that witnessed the two eras – 10 years before mandatory IFRS adoption and 10 years after the mandatory year of adoption - 2005.

Following the recent increased rate of IFRS adoption among nations of the world and on the premise that earnings management is a global phenomenon, this study seeks to critically examine the influence that adoption of IFRS has had on the financial reporting quality of companies across the globe with a focus on earnings management. Hence, the objectives of this study are:

1. To critically examine the effectiveness of IFRS in curbing earnings management across countries, considering their economic classification
2. To assess the beneficial impact of IFRS adoption on the firm's ability to raise more capital in the capital market.
3. To evaluate whether engagement of any of the Big Four audit firms could enhance the effectiveness of IFRS in promoting financial reporting quality.
4. To assess the relevance of economic status, human development and governance infrastructure of countries to IFRS adoption and earnings management.

1.5 Research Questions

Therefore, this research seeks to answer the following questions:

- i. Given the difference in the economic status, governance infrastructure and human development among countries, to what extent has adoption of IFRS enhanced financial information quality with a focus on EM?
- ii. How adequate is the IFRS in promoting financial reporting quality by curbing EM?

1.6 Research Contributions

The literature documents mixed and inconclusive findings on the impact of the adoption of IFRS on earnings management (Capkun *et al.*, 2012). Major studies conducted on the subject focus on developed countries while others focus on one country (Paananen, 2008; Tendeloo and Vanstraelen, 2005). Few works exist on the combined treatment of the international perspectives of earnings management and international accounting standards (IAS or IFRS). The existing

literature fundamentally either treats the international perspective of earnings management or general view of IFRS adoption (Leuz *et al.*, 2003; Shen and Chih, 2005; Joshi *et al.*, 2016).

The first multi-country study on the influence of the International Accounting Standard on earnings management by Leuz *et al.* (2003) was before the year IFRS was mandated among the EU members. The study is also limited to how earnings management affects investors' protection. In line with this, Shen and Lin (2013) studied 48 countries to assess the impact of earnings management on investor protection using prospect theory. However, the study concentrates solely on the banking sector. Unlike earlier studies that focused on a few countries (Zeghal *et al.*, 2011), one country (Sellami and Fakhfakh, 2014; Rudra and Bhattacharjee, 2012) or solely EU countries (Capkun *et al.*, 2008), this research carefully selected ten countries, with each half of the sample representing either of the two economic classifications: developed and emerging economies.

To the best of my knowledge, this thesis is the first multi-country study to comparatively evaluate the impact of IFRS on accounting earning quality with due consideration to the economic status of the countries studied. Also, this research presents a fresh view of the impact of IFRS in curbing earnings management by comparing the results of developed economies with that of emerging economies. Through this, evaluation of the universality of the uniform standard and its fitness to emerging economies can be assessed. This research builds on the work of Ball (2016) to empirically test for the implications of IFRS adoption on earnings management after a decade.

Apart from incorporating more years and more sectors, this thesis considers the stage of economic development, human development, governance and political infrastructure of the countries studied. The justification for including these institutional and country-inclined

factors is that *ex-ante* literature established that the efficacy of the IAS/IFRS in promoting financial reporting quality is not solely dependent on the standard but also on the institutional framework for its operationalisation (Zeghal *et al.*, 2012; Jeanjean and Stolowy, 2008). Prior studies did not consider these aspects. More importantly, the study methodologically divides the world into two economic classifications. The purpose of this is to evaluate the sensitivity of the influence of IFRS adoption on EM to economic development.

Although adoption of IFRS came as a necessary change to all countries where the accountancy profession is practised, not all countries are prepared for it. The institutional factors of every country are shaped by their beliefs or religions, culture, who colonised them and stage of development (Zehri and Abdelbaki, 2013; Kolsi and Zehri, 2013; Zeghal and Mhedhbi, 2006). Aside from this, IFRS originated from the Confederation of a few developed EU countries. However, given the extent of diffusion of the standard among countries of emerging economic status, this research adds to existing knowledge by critically examining how the IFRS has impacted the quality of financial statements (specifically with regard to earnings management) of firms in the countries that witnessed its inception and firms in countries reactively adopting the standards.

The impact of globalisation on countries of the world cannot be denied. Analysing the financial statements of firms based on firm-specific variables that connect or relate them to their countries alone will present a partial view of such country. There is a need to incorporate variables that examine firms of a country in relation to firms of other countries of the globalised world. In other words, given the popularity of IFRS among countries of the world and that earnings management is a global phenomenon, both the microeconomic (firm-specific) variables and macroeconomic (country level) variables as factors influencing IFRS

adoption and earnings management ought to be considered (see methodology chapter).

Earlier researchers establish a negative correlation between accounting quality and earnings management (Ewert and Wagenhover, 2005). Further, countries with higher accounting quality are equally identified with reduced incidence of earnings management (Houque *et al.*, 2012; Leuz *et al.*, 2003; Shen and Chih, 2005). Therefore, this study is unique in drawing its pool of samples from both developed and emerging economies to assess how the adoption of IFRS has globally impacted on earnings management. In other words, given the prominence of IFRS worldwide and the global practice of earnings management, this study, uniquely examines the efficacy of the standard against EM to derive a conclusion that will be of global relevance.

1.7 Scope of Study.

Since it would amount to a herculean task to study all the countries of the world, this research studies ten countries that adequately fit into the classifications of developed countries and emerging economies (see footnote 6). This is in line with the current debate as to whether, after a decade of implementation, the impact of IFRS adoption can be reliably discerned or not (Ball, 2016). Consistent with this view, this thesis empirically examines the implications of IFRS adoption on the quality of reported earnings on a ten years before and ten years after basis. The study analyses a pool of data of firms in Germany, Australia, France, Italy and the United Kingdom as a representative sample for developed economies. Financial data of firms in China, India, Malaysia, Brazil and South Africa were pooled together as a representative sample of emerging economies.

1.8 The organisation of the study

The next chapter of this thesis reviews the institutional background of the study. Chapter three reviews the literature, while chapter four focuses on the theoretical framework and hypothesis development. Chapter five discusses the research methodology, while chapter six sets out the data analyses and discussion of results. The thesis ends with chapter seven in which the summary, conclusion and recommendations of the study are discussed.

Chapter Two: Institutional Background

2.0 Introduction

Series of studies have been conducted on the impact of IFRS adoption on factors such as cost of equity, the financial performance of firms and the quality of accounting information. Most of these studies affirm that IFRS adoption promotes transparency and improves the quality of published financial reporting (Daske *et al.*, 2008; Amiram, 2012; Ahmed *et al.*, 2013). However, the literature has it that the financial reporting quality differs in line with the degree of investors protection available in each country (Leuz *et al.*, 2006; Ball *et al.*, 2003, Burgstahler *et al.*, 2006). Furthermore, even though the adoption of the IFRS is expected to encourage uniformity of the basis on which financial statements are prepared (IFRS as against countries' GAAP), the level of earnings management among countries varies (Houque *et al.*, 2012). The diversities of culture, the extent of compliance among countries and the interpretation of the standards might reduce the comparability of published financial statement (Doupnik and Perera, 2009).

Extant studies have not considered the diversity in economic and operational settings of the developed economies and emerging economies in relation to IFRS adoption and how this has influenced the quality of financial reporting. While prior studies argue that strong governance, efficient capital market, skill and knowledge of users (measured as Human Development Index in this study) have made adoption of the IFRS impactful among developed countries. The opposite is the case with emerging economies (Irvine and Lucas, 2006; Judge *et al.*, 2010). Hence, this chapter provides the institutional background to the study. This is to provide a foundation to the sensitivity of the Institutional setting of the reporting firms towards the

efficacy of IFRS adoption in promoting the quality of published financial statements.

2.1 The Relevance of Uniform Accounting Standard to Highly Diversified Countries

A relevant question to ask is: to what extent can the uniform standard ameliorate the poor accounting systems in countries with high diversity in their institutional features? The high level of socio-economic diversity in Africa as a continent is another argument for its non-readiness for the IFRS. Unlike European Union countries, where the introduction and enforcement of communal regulations are smooth, African countries barely agree on mutual regulations, and enforcement of the existing ones is also a challenge. For instance, the local bodies AU and ECOWAS barely agree on regulations that border on benefiting their member citizens.

Furthermore, in consideration of the African continent, lack of a consistent voice has complicated the issue. This has diluted the power of the united voice of African countries, contrary to what is obtainable from other continents whose representatives speak with one voice. Usually, every country is represented in IFAC and IASB by their representatives in deciding issues that affect their financial reporting systems. The implication of this is that Africa's 54 countries are not getting the appropriate audience and influence in the polity of the standard setters due to lack of unity.

On comparability of financial statements, one may wonder how this could be achieved in a continent with such significant economic differences. Some African countries are naturally endowed with resources, while others generate their income from taxes. Some have the public sector dominating their economy while for others, the private sector is predominant. Also, if we assume that African countries are ready for adoption of IFRS, what would be the basis for measuring the

benefits and how would it be measured as each individual country would be left to administer the standards?

The fairness in the fair value

The proponents of IFRS adoption have argued that fair value accounting contributed to the recent financial global crises (Botzem and Sigrid, 2009). Botzem *et al.* (2017) called it the ‘fair value accounting beast’. Cases of problems have been observed in some countries (for instance Portugal and Greece) that adopted IFRS recently. The question is to what extent can IFRS benefit the economies of these countries? Based on fair value, is there any way we can adjudge these countries to be at par regarding market efficiency? How comparable are financial statements prepared based on IFRS in the UK with those of South Africa? Can we place a country with no stock market and an unstable economy such as Somalia on a similar platform with Greece as far as financial reporting is concerned?

The survival of the African economy through the global financial crises, as opined by the IMF, was said to be dependent on adequate economic policy, reduced inflation, steady economic growth, reduced the national debt and increased foreign exchange reserves (IMF, 2011; Botzem *et al.*, 2017). Having noted the impact of IFRS on the crises, the EU and the G20 were able to weather the situation through ‘bailout packages’.

The cost to benefit analysis

Considering the cost to benefit analysis of IFRS adoption is another pertinent issue. The reasons most emerging economies adopt the IFRS hook, line and sinker are not far from two primary factors: difficulty in design and implementation of accounting standards and cost of implementation of the designed standards. The cost is usually enormous and serves to reduce the country’s wealth.

The paradox of this is that quantifying the costs of IFRS in monetary terms is far more comfortable than quantifying the benefits from it. However, there is a tendency to have the cost of capital reduced on the implementation of IFRS. This may not be realistic in less developed capital markets where investors are not willing to pay any premium that justifies an efficient financial reporting system and where the benefits attributable to its adoption outweigh the costs. The president of the Organisation pour L'Harmonisation en Afrique du droit des affaires (OHADA), Christian D. Migan, asked: how would the cost of the implementation of IFRS be borne by African countries such as Togo, Chad, Benin, Burkina Faso and other OHADA regional countries which have no capital markets and with nearly 80% of their companies being small-scale entities (Botzem *et al.*, 2017).

The gains of the Big Four audit firms and the pains of their clients

The literature has it that the Big Four audit firms are the fundamental motivating force behind the setting and introduction of the IFRS. Considering the lack of technical expertise in developing countries, then transition to IFRS might necessitate contracting the services of the Big Four accounting firms, which will also result in 'Big' cost. Auditors love advocating changes, especially those that their client cannot handle (e.g. OBS - Off-Balance Sheet transactions). They also profit from the opportunity (Botzem *et al.*, 2017).

Since it is challenging to separate the socio-economic and political realities of any country from its accounting system, it would be better for countries to shape their accounting systems according to their 'shape' and in line with their needs and for the mutual benefit of the continent. It is glaringly obvious that IFRS is ready for Africa, but Africa is not ready for IFRS.

2.2 A Review of IFRS Adoption in Emerging Economies.

Developed economies such as the US, UK and France, have consistently been viewed as models of financial reporting and vital regulatory players in the capital market before the advent of the global economic meltdown of 2008. However, the scandals in financial reporting suffered by some of their corporations have eroded investors' confidence as far as the reliability of accounting figures is concerned (Alzoubi and Selamat, 2012). This led to managerial dilemmas in persuading potential investors of the performance of their companies and meeting the expectations of stakeholders on what the future holds for their companies (Graham *et al.*, 2005). An inference could be drawn from this on the relevance of economic status of a country to the quality of its financial reporting system on the adoption of IASs/ IFRSs.

Literature abounds on international accounting standards as it affects the operational systems of accounting in developed economies. However, few works exist on the impact of international standards on the financial reporting systems of emerging economies. Although most of these countries apply local GAAPS alongside the IFRSs/IASs, some countries such as Thailand, Nigeria, Pakistan, Bangladesh and the Arab Gulf Countries Co-operation Council (GCC) adopted the standards without adjustments. Meanwhile, some countries such as Zimbabwe and Iran want the IFRS to be consistent with their laws and regulations (Chamisa, 2000; Mashayekhi and Mashayekhi, 2008; Faraj and Essa, 2014).

The adoption of IFRS is either motivated by the groups of companies or by the government of the country. The governments of the EU, Bangladesh, GCC and Pakistan enforced their adoption. Conversely, countries like the United Arab Emirates (UAE) and Bahrain had theirs by the companies operating within their territories (Zeghal and Mhedhbi, 2006). The UAE for instance, took adoption as an opportunity

because of the ineffectiveness of their accounting profession. The critical issue about this is ascertaining the tendency of coping rightly with international standards when a country finds application and enforcement of their standards difficult.

The motives behind the adoption of the IAS according to literature include improving financial report quality, promoting economic growth, attracting foreign direct investment (FDI), meeting external auditors' requirements from international corporations and enhancement of accounting education. These factors are discussed in the subsequent paragraphs.

Improved financial reporting quality

Based on the argument on whether adoption of IFRS improves the quality and value relevance of financial reports, some scholars opine that from the perception of auditors and accountants, IFRS would promote clarity and reliability of financial statements as well as reduce fraud incidence (Bozkurt *et al.*, 2013). Investors expect financial statements that genuinely represent the state of affairs of a business organisation. However, this has long been abused by managers and accountants under different names as such creative accounting, earnings management and earnings manipulation. This makes it difficult to discern if they are legal acts or not and, hence, has stirred many arguments in academia.

The literature documents the impact of the adoption of IFRS on financial reporting systems of organisations. Empirical findings by Jones and Higgins (2006) suggest that the adoption of IFRS is expected to impact the financial reporting practices of companies in Australia positively. Christensen *et al.* (2008) also found that German firms that adopt IAS were found to have improved accounting quality. In the opinion of Iatridis and Rouvolis (2010), the adoption of IFRS enhances credibility and financial reporting quality of Greek listed firms.

Soderstrom and Sun (2007) also discovered a positive relationship between IFRS adoption and accounting quality of EU companies. However, evidence on the impact of IFRS adoption on accounting quality in emerging economies is scarce. The research results from Jordan by Rawashdeh (2003) also disclose that IASs are more informative and give credence to investors. Studies by authors like Wang and Campbell, (2012) and Zeghal *et al.* (2011) on China and France respectively are country specific. The findings might be influenced by the economic climate peculiar to each country and generalisation of these would be impractical.

In line with this, governments of the GCC countries also presumed that the adoption of IASs would make vital information available to investors and make financial statements more comparable. However, in line with this research, Barth *et al.* (2008) examine 21 countries of both developed and developing status to discern whether the accounting quality of firms is related to the application of IASs. They discovered that firms that applied the IAS/IFRS have a higher quality of accounting reports than companies that do not.

Economic growth

There is a likelihood of economic growth where the expectations of investors and other users are met through the quality financial reports produced applying international standards. According to Barker *et al.* (2013), adoption of IASs enhances transparency and disclosure of relevant information useful to international investors in the competitive international capital market. The ultimate result of this is economic growth. Larson (1993) empirically studied the adoption of IAS and economic growth of emerging economies and discovered that countries that have adopted IAS display increased economic growth. Similarly, Al-Akra *et al.* (2009) find that following the intention of Jordan in adopting IFRS, reformation of accounting practices and economic

factor such as privatisation could be facilitated. However, the linkage between IASs and economic growth has been debated by some authors.

The findings of Zeghal and Mhedhbi (2006) show that the adoption of IASs does not have a significant impact on the economic growth of emerging economies studied. Further, Larson and Kenny (1995) argue that adopting IASs is not the only factor that could make countries achieve higher economic growth and that investors' confidence is boosted where financial statements are reliable. This is of paramount importance for capital market development. A developed capital market will ultimately impact positively on the economic growth of the country. For instance, China's significant economic reforms started with the reformation of its accounting system, which has contributed immensely to the development of the Chinese domestic economy (Rutledge *et al.*, 2015). To the best of my understanding, this link has not been studied in the context of IFRS adoption. Hence, it is one of the objectives of this research.

Foreign Investments

Foreign companies in emerging economies are a source of motivation for some companies in adopting IASs. Al-Shammari *et al.* (2007) discovered that an increased number of foreign banks that adopted IASs voluntarily in the Kingdom of Saudi Arabia and Qatar provoked their governments into enforcing the adoption of the standards. They equally observed that adoption of the IAS by the governments of GCC countries was triggered by pressure from multinational corporations. For instance, to develop its local accounting standards, Iran adopted IASs, and this has led to the attraction of FDI as a result of improved financial reporting (Mashayekhi and Mashayekh, 2008). Dobija and Klimczak (2010) also discovered that the introduction of the IASs/IFRSs in Poland reduced the gap between their GAAP and the IAS, thereby fostering harmonisation of financial reporting practices. This has

ultimately induced attraction of FDI. Evidence from Russia, in the findings of Preobragenskaya and McGee (2003), shows that lack of credibility in the financial reporting system of Russian firms led to a reduction in foreign capital into the country.

External Auditors

There exists evidence from the literature that there is a link between the auditing profession and the adoption of IASs. For instance, in Bahrain, auditors advised their clients on the adoption of IAS (Al-Basteki, 1995). In addition to this, Joshi and Ramadhan (2002) opine that the accountants of small enterprises viewed the relationship between the role of external auditors and the adoption of IASs by Bahrain companies as direct. The pre-occupation of auditors is to ensure that financial statements are prepared according to the accounting standards and regulatory requirements of the country in which their client is domiciled. According to Rahman *et al.* (2002), the Big Four firms play a significant role in the global harmonisation of accounting practices. They are perceived to have initiated their support in 1973 while contributing to the establishment of the IASC and are still supporting the IASB.

German companies that are audited by the Big Five firms (now Big Four) were, according to the findings of Glaum and Street (2003), found to have a higher level of compliance with IASs than firms that are not audited by the Big Five. In the same direction, Prather-Kinsey and Meek (2004) studied the level of compliance of companies of various countries and discovered that greater accounting information disclosure and better compliance with the requirements of the standard were identified with companies that are audited by the Big Five. The role of international auditors on IFRS adoption is inevitably strong as they are viewed as pacesetters in the auditing profession across countries.

International Donors, Lenders and Corporations

International organisations like the International Monetary Fund (IMF) and the World Bank (WB) will have free course in their dealings with countries whose accounting system is IAS or IFRS compliant. WB and the IMF consistently insist on IFRS adoption as a condition for finance to countries (Rahman, 1994 and Chamisa, 2000). The research conducted by Mir and Rahaman (2005) reveals that this requirement is a significant factor that motivates accounting bodies and government, especially of emerging economies, in their decision to adopt the IFRS.

Accounting Education

The degree of literacy has been found to correlate positively to the decision on the adoption of IFRSs. This was confirmed by Archambault and Archambault (2009) while assessing the decisions of 120 countries on IFRS adoption among listed companies. Also, while examining the factors influencing the adoption of IFRS in developing countries, Zeghal and Mhedhbi (2006) discovered that countries with higher levels of literacy are more interested in adopting IFRS. Further, the decision to adopt the IFRS positively correlates with the rate of literacy of countries studied. In more specific terms, poor accounting education may hamper the successful implementation of IFRSs. Outdated curricula, inadequate faculty members, and outdated teaching methods are some of the challenges faced by the accounting profession which hinder the implementation of IFRS in one way or the other. Evidence from Jordan gathered by Al-Akra *et al.* (2009) suggests that sound teaching of accounting and auditing will help in the smooth implementation of IASs/IFRSs.

Adoption of IFRS and the Readiness of African Countries

For almost ten and a half years now, more than 130 countries around the globe have indicated their interest in IFRS. Out of these, 13 are African countries. The figure from Africa includes countries that have wholly adopted the standard and countries that have modified the IFRS

and their accounting system in line with their socio-economic needs. However, there is a controversy on Africa countries adopting the standards as encouraged by international organisations such as the World Bank, USAID, WTO, and UNCTAD. The question is, how suitable is IFRS adoption in African countries? The following are the arguments against the motion:

Politics versus Economics

Initially, adoption of the IFRS as a uniform standard was argued to have encouraged comparability of published financial statements among companies in their respective countries. Dividends will reflect minimised risk due to information asymmetry. Information processing cost and cost of equity capital will reduce, and transparency of financial reports will be enhanced. However, as beautiful as this may sound, achieving these results cannot be guaranteed in every country.

Further, developing economies were never envisaged while developing IFRS. In other words, these EU crafted standards were targeted to developed economies whose capital markets are developed. Hence, the move to adopt IFRS by the developed economies of the world is a welcome idea. However, while the financial statement is the basis on which investors make informed decisions on buying and selling valued stocks, how do countries with poor or no capital markets fit in IFRS adoption if placed on the open invitation as it is? This does not mean that such countries do not need to prepare quality financial reports. Nevertheless, it is understandable that their reporting requirements will differ from that of the developed economies where developed capital markets exist.

Every country has accounting systems reflecting its social, economic, legal, political and cultural conditions. Hence the differences in the economies of the world will also result in differences in accounting needs, which will also reflect in financial reporting systems. Therefore,

the quest to know how the adoption of a uniform standard can fit in every economy about the promotion of credible financial reporting is a green research area.

Convergence by the Strong or Adoption by the Weak

The adoption of IFRS has turned the world into a battle-ground between the weak and the strong. In the name of IFRS adoption, some of the so-called large economies such as Canada, Japan and Russia have just succeeded in converging the standards to suit their economic need. However, many of the ‘obedient fellows’ in less developed countries strive to adopt all without modification (Botzem *et al.*, 2017).

Double standards accounting

A school of thought opines that the speed of development of a country must match the soundness of its financial reporting systems especially in the current era in which micro-financing is being used as a catalyst for development in developing countries. Since many African countries are now growing economically, this has led to an inflow of FDI and the attraction of more investors. Hence, a call for soundness and transparent financial reporting systems through adoption of IFRS should justify the capital market interplay.

Conversely, another school of thought supported by Perera (1989) and Patterson *et al.* (2004) emphasise that investment made by investors in a country was irrelevant to the financial reporting system of that country. In their opinion, some countries may still refuse to adopt the IFRS despite their reliable financial reporting systems and laws protecting investors. In the words of Botzem *et al.* (2017), countries with weak financial systems often see the adoption of IFRS as a haven of rest in which they can hide. Therefore, justifying IFRS adoption based on economic growth could be a misconception because, when the

currently developed economies were in their developing state, their accounting standards differed fundamentally from IFRS.

Adoption of the IFRS at the current stage of development might be a curse rather than a blessing for emerging economies. It should, therefore, not be taken as a solution to their flawed financial systems but a threat to it. In the report published by the South African Institute of Chartered Accountants, the UN and IMF predicted growth in GDP of African countries by 5% in 2011 with the prescription of IFRS being the way out. The report further emphasised the need for a uniform accounting system for the continent (Botzem *et al.*, 2017).

While this might be partially true, the main bone of contention is the enforcement of the standards and not single-voice financial language. This also does not exonerate the consideration of whether total adoption of IFRS or its modification will be advantageous to emerging economies, especially African countries. It is surprising that some advanced economies did not adopt the IFRS as the IASB issued it. This has given rise to the global accounting profession being ruled by double standards. Currently, the United States of America has still not adopted IFRS. According to Botzem *et al.* (2017), if the USA consents at all, it is likely to dwell on the convergence zone and not on total adoption. Examples of countries in similar condition include Canada, China, Japan, Australia and New Zealand. However, the few countries that have subscribed to IFRS adopted it as prepared by the IASB. Therefore, if a uniform accounting system must be enhanced as one of the primary motives for IFRS, there should be uniformity in its mode of acceptance. In other words, starting from the developed nations, if it is convergence let all countries converge. Also, if it is adoption, then uniformity must be upheld.

2.3 Review of the Emerging Economies used in the Study

South Africa and IFRS adoption

South Africa became a British colony in 1652. While still under the colonial administration of Great Britain, it was allowed a colonial self-governance in the name of Union of South Africa in 1910. South Africa gained her independent in 1931 and became a republic thirty years after in 1961 on leaving the Commonwealth Nations. This long year of connection with Britain mirror in the governance and legal system of the country as South Africa adopted the common law of Britain (Prather-Kinsey, 2006).

The South African corporate reporting is anchored on the Companies Act (No. 61) of 1973. Nonetheless, the development of a procedure for standard setting goes beyond the scope of the Company Act. In South Africa, the standard setting procedure passes through two bodies: The Accounting Practice Board (APB) charged with the responsibility of approving and issuing accounting standards, and the Accounting Practices Committee (APC) who acted in an advisory capacity to the APB. In 1995, the standard setters of South Africa decided to adopt the IAS but adapt it to their local settings. This gained the full support of the South African Institute of Chartered Accountants (SAICA), Johannesburg Stock Exchange and the APB of South Africa in a bid to join the global economy about financial reporting. Ever since 1995, the SAICA has been using the international accounting standards, though with little adjustments over the years (Prather-Kinsey, 2006).

The JSE made the pronouncement in October 2000, requiring all listed companies to prepare their annual financial reports in compliance with the Companies Act relevant to listed companies with the option of using either the national GAAP or International Accounting Standards. After the publication of the final version of the amendments of JSE listings Requirements on 15 May 2003, the JSE made it mandatory for all listed

firms to IFRS as the basis for the preparation of their financial statement commencing from 1 January 2005. Sharing a feature with the European countries that adopted IFRS, South Africa has two categories of companies applying IFRS: that that adopted voluntarily before 2005 and those that adopted it in 2005.

South Africa is a common law country with keen investors' protection mechanisms. The country is also one of the early adopters of the International Financial Reporting Standards (IFRS). However, mixed findings exist in the literature about the impact of the adoption of IFRS on the quality of financial statement in South Africa. Ames (2013) finds that the quality of financial statement does not improve on adoption of IFRS. This result is also confirmed in Chebaane and Ben-Othman (2013) that adoption of IFRS does not in any way reduced the incidence of earnings management in South Africa.

On the contrary, Ames (2013) establishes a significant difference between the pre-IFRS adoption and the post-IFRS adoption reported earnings. However, with a positive association, contrary to the expectation of negative coefficient, he observed that adoption of IFRS does not significantly impact on the earning quality of South African firms. The result was attributed to the less conservative nature of IFRS, especially on revenue recognition and leniency on the part of auditors in the application of the new standards. The author also admits the tendency of the result being impaired by inflation.

Although not denying that adoption of IFRS might have, on the average, contributed positively to the economy, in his perception, the insignificant relation between IFRS adoption and earnings management could be traced to macroeconomic factors. For instance, 2005-2007 as a post IFRS adoption period were adjudged as favourable years until 2008-2009, the periods of global recession and financial crises. Apart from the general global financial crises, South Africa is not without her

peculiar challenges such as inadequate power supply and upsurge interest rate (Selassie, 2011).

On the contrary, Sellami and Slimi (2016), in a recent study examining the traceability of reduction in earnings management among South African firms to IFRS adoption; using a regression model. Having studies 46 firms, the results revealed reduced earnings management among South African firms. Implying that adoption of IFRS in SA is a plus to the quality of financial information in the country. The authors classified their study into the 2002-2004 pre-adoption period and 2010-2012 as the post-adoption period. However, the 2005-2009 not accounted for leaves a gap in the study period. This might impair the reliability of the results.

Following this, a more comprehensive methodology and control variable are adopted in this study to cater for the macroeconomic variables which Ames (2013)'s result could not explicitly explain. The year of analysis of this is from 2000 to 2015, which make this thesis historical and robust.

China and IFRS adoption

China is a code law country with weak investors' protection and low risk of litigation. Evidence exists in the literature those firms in code law countries with poor investors' protection practice more of earnings management than those in the common law countries with high investors' protection (Lourenço, 2015). This implies that the likelihood of EM due to the flexibility that IFRS permits might be high. Therefore, it is expected that EM would be on the increase among Chinese firms following the adoption of IFRS. Sharing cultural similarities with Taiwan, the Chinese capital market uses two different accounting standards for individual companies.

Traditionally, the accounting infrastructure in place in China was designed around the socialist economic system practised in China, where the government controlled the means of production centrally. In other words, the accounting standard in force was to provide financial information to the government at their various levels, as needed for planning and controlling the economy. However, this later proved to be inadequate to reflect the economic growth and status of the country (Rask *et al.*, 1998; Xiang, 1998).

As China became stronger economically, evidenced in their economic growth, increased exportation of technologies, and its outreach to the international community in joint ventures and capital market and moved towards a market-based economy, they realised the inadequacy of their accounting system early enough. While transforming from a centrally planned economic system to a market-based system, the need for a more complex accounting system that can meet the need of investors, creditors management, government and that can serve as a reasonable basis for performance evaluation measure was soon realised. This process has been on for the past two decades.

The findings of Peng and Smith (2010) in their evaluation of the process of convergence of China's GAAP with IFRS for the period between 1992 to 2006 revealed that China's local standard is continuously converging with the IAS/IFRS especially in consideration of moving from cost to fair value basis. In addition to this, China was observed to have changed its accounting system towards treating financial transactions of companies from a selection of alternative treatments that the flexibility in IFRS affords unlike following specific requirements which the local standards advocates. China's accounting reporting system requires more disclosures, details and is getting more enforcement with stricter methods. China's progressive convergence with IAS/IFRS directly impacted on capital markets and economic

development of the country. On this basis, China can be presumed to be an advocate of harmonisation of international accounting.

The organisation in charge of issuing of the Chinese accounting standard is the Ministry of Finance of China. The issue of the Basic Standards, Accounting Standards for Enterprises No. 1- in 1992, marks the turning point of Chinese Accounting System in the direction of the international Accounting Practice (Zhou *et al.*, 2007). Though the standard was patterned after the western accounting system, it is different from Western accounting standards being less detailed and excluded compounded liability issues (Winkle *et al.*, 1994). Subsequent standards have been issued by the ministry all which were issued to enhance the financial reporting system in China, qualitatively and quantitatively.

Chinese listed companies issue two types of shares as traded on their Shanghai Stock exchange and Shenzhen Stock exchange: The A-shares and the B-shares. While the A-shares are issued to Chinese citizens and domiciled in Yuan, the B-Shares are traded patronised by foreign investors and issued in US dollars. Although the two variations of shares carry equal rights, they, however, differ as far as their ownership is concerned. Also, A-shares firms' reporting system is based on the Chinese GAAP, and their financial statement is audited by indigenous CPAs, while the B-Shares firms report their financial activities based on IFRS. Also, they are mostly audited by international audit firms.

Studying the impact of the convergence of China's Accounting Standards with the IFRS and its relevance to Chinese accounting reporting quality is important due to the increasingly vital role played by the country in the global economic system, mainly as a leading exporter. The study of Hawksworth and Tiwari (2011), predicted China to be the world's leading economy with the expectation of leading the US by 2020. In addition to this, the country is a capitalist state and a

large transitional economy having government-controlled capital market and market-controlled capital market. Hence, research evidence and inferences from China on how IFRS has influenced her accounting quality would be of high relevance to other emerging economies. Further to this, the research on the convergence of Chinese Accounting Standard to IFRS and how this has either encourage or discourage earnings management is a thought-provoking issue that demands global consideration by practitioners, academics, standard setters and regulating institutions.

Noteworthy also is the fact that the Chinese legal system and investor protection mechanism is not as secure as those of developed economies. As observed by Allen *et al.* (2005), the countries of French legal origin have investor protection than as enjoyed in China. This inadequate investor protection mechanism has been argued by Morck *et al.* (2000) to be the fundamental reason behind the frail corporate information system in China. Most prior cross-country studies fail to incorporate essential institutional features. Hence evaluating measuring the extent to which China's convergence to IFRS has impacted the quality of her financial reporting system is pertinent.

The literature has mixed evidence of the impact of IFRS adoption on the earnings quality in China. The findings of Liu *et al.*, (2011) revealed that earnings quality measured by reduced earnings management among Chinese firms improved on adoption of IFRS since 2007. This was supported by the findings of Sang-Kyu and Jing (2012) demonstrated that adoption of IFRS impacted positively on the quality of reported financial statements evidenced by reduced earnings management among Chinese firms. However, this was contested by He *et al.* (2011) whose findings revealed increased earnings management on adoption of IFRS due to the fair-value accounting attribute of the standard. In this direction, the study conducted by Li and Park (2012) also showed that earnings management is more pronounced among

Chinese firms after the adoption of IFRS than before the adoption. This practice is mostly identified with firms having a high inclination towards avoiding reporting losses.

On the other hand, Wang and Campbell, (2012) found no significant proof that earnings management reduced (earning quality improved) while Chinese firms report under IFRS than it would if it were under the CAS. Hence according to their findings, adoption of IFRS does not reduce the incidence of earnings management in China. Similarly, having studied earnings management of the Chinese firms on pre and post IFRS adoption basis, Li *et al.* (2013) found that the principle-based standard encourages greater earnings management and reduced earnings quality among firms in countries having poor enforcement system. These conflicting findings incubate uncertainties as to whether IFRS adoption or convergence of CAS to IFRS improved the quality of earnings reported (lead to reduced earnings management) among Chinese listed firm. Hence this thesis, intend to study the impact of IFRS on earnings management among listed Chinese firm using more years than too few years used in earlier studies.

In China context, using discretionary accrual measure of earnings management, EM is observed reduced after the adoption of IFRS in 2007 (Liu *et al.*, 2011). However, these findings were challenged by Wang and Campbell, (2012) that no significant evidence supports that the adoption of IFRS enhances the quality of financial reporting system of Chinese firms than their GAAP will do. In furtherance of this, Li and Park (2012) assert that implementation of IFRS does not appear to reduce earnings management in China. According to them, more of EM was discovered after IFRS adoption than before its adoption.

Examining the effect of IFRS adoption on earnings management of sampled Chinese firms, Zhou *et al.*, (2009) observed decreased earnings management. Contrary to this, Sang-Kyu, and Jing (2012), while

examining the effects of IFRS adoption and ownership structure, find that an increase in the level of earnings after the adoption of IFRS. This confirms the argument that the principle-based standard allows opportunistic behaviours by managers.

The result of this study shows increased earnings management among Chinese firms following the adoption of IFRS. This contradicts the results of Liu *et al.* (2011). The discrepancy might be because of the different methodology adopted in the studies. The Big4 four also shows the positive direction in line with the level of discretionary accruals. In addition to this, it is not statistically significant. It presumed that these research findings could serve as a representation for the adoption of IFRS in Asian countries. Hence, the first hypothesis can be substantiated for China that there is a positive relationship between IFRS adoption and EM.

Malaysia and IFRS adoption

The accounting profession in Malaysia has two principal players: The Malaysian Association of Certified Public Accountants established in 1958 and the Malaysian Institute of Accountants established in 1967. As a member of the International Accounting Standard Committee, the former started implementing the international accounting standard in 1978. Nonetheless, in 1994, the two bodies mutually issued Malaysia Accounting Standards. The IASs and MASs received continuous developments until the establishment of the Malaysian Accounting Standard Board that officially took over the administration of the accounting standards in 1997.

Later, the Malaysian Accounting Standard and the Financial Reporting Foundation was charged with the responsibility of the activities of the Malaysian Standard Board. This is what motivated the government on the need for the revitalised Malaysian accounting system. Official announcement to this effect was made in December 1996. These bodies

formulated the Malaysian financial reporting framework, which shared generous similarity with the IASC's framework. The MASB has started working towards harmonisation of both the Malaysian Accounting Standard and the International accounting standards into a new standard adaptable to Malaysian setting. Since 2004, this numbered to 32 standards and one Islamic standard (Tan, 2000; Saudagaran, 2005).

Sequel to this, in late 2004, the Malaysian accounting standard-setting body declared their intention for all listed companies to adopt IFRS by Jan 2006. They tagged it 'Financial Reporting Standards' (FRS). Adoption of IFRS in Malaysia thus makes a dominant impact on its financial reporting system due to its excellent value. This has a significant implication in its standard relating to share-based payments (FRS2), business combination (FRS3), property plant and equipment (FRS116), impairment of assets (FRS136), intangible assets (FRS 138) and investment properties (FRS140) (Rad and Embong, 2014). With fair value reporting adopted in preference to historical-cost accounting, financial reports become more credible, relevant, timely, credible and transparent.

Apart from fair value attribute of the IFRS, it also promotes a higher level of disclosure. FRS 136 for instance, relating to Impairment of Assets emphasis the need for more disclosure on the goodwill and other intangibles, particularly about the allocation of goodwill to cash-generating units. The principal basis of measurement of re tendency of impacting on the quality if financial reports (Rad and Embong, 2014).

India and IFRS adoption

The evolution of Indian accounting standards is traceable to the sixteenth century because of its international transactions between the European countries and other Asian countries. The emergence of the East India Company further impacted on commercial activities in India lead to the dominance of the company's shareholders on the economic

affairs of the country. Having spotted the prospects of human and natural resources as bordering on the commercial activities of India, the British government acquired the East India Company after colonising India. This led to the similarity in the treatment of financial transactions in the financial reporting practice of the two countries to be similar (Marston, 1986). Conversely, on the attainment of her independence in 1947, the Indian Financial reporting system changed in alignment to her unique economic needs.

India has twenty-eight states, eighteen official languages (as well as many dialects), seven union territories and predominantly an agricultural economy. The states respectively have their specific culture and the common way through which their commercial activities are consummated. Hence, as might be expected, the accounting practice of the country reflects her diversities. Also, a good number of firms are family controlled and are very conservative about revealing their financial information out of fear of being vulnerable to competitors. In addition to this, the accounting practice of the agricultural sector is still naïve and lacks uniformity, just as it is obtainable in the small-scale industrial firms situated in the urban areas. Therefore, launching a standardisation campaign for uniformity in accounting practices among these sectors is a compound exercise.

Furthermore, the country is characterised by a low level of education with the majority of her population in the rural area. India's primary income comes from agriculture. However, no accounting system is in place to back this up. Language barrier further aggravates the possibility of promoting uniform accounting practice among sectors of the country. The grassroots governance system introduced by the late Rajiv Gandhi, former Indian prime minister, challenge the status quo towards the enhancement of the economy.

Nevertheless, India is a prominent leader in space research and satellite technology, numbered as one of the leading industrialised countries in the world and a military superpower (Perumpral *et al.*, 2009). The economic shock experienced in India in 1991 led them to seek intervention from the International Monetary Fund (IMF). This led to the introduction of major alterations in the economic policy of the country; such as reduced subsidies, privatisation of some of the public enterprises, increased taxes and encouraging foreign investors through the open market economic system (Perumpral *et al.*, 2009; Anderson and Lanen, 1999).

The establishment of more transnational corporations in India because of this now led to India being a key exporter of industrial and consumer goods, technology as well as financial services. This further promotes the alliance of the country with international organisations like the World Bank, International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development. Still, the public sector retains its control of national defence and security and related companies due to their relevance to the economy of the country.

The Companies Act, 1956 provides legal coverage for the accounting practices of the public and structured private sector in India. The Act has many similarities with the International Accounting Standards. Two reasons might have accounted for this: this might be as an extrapolation of accounting practice as gained during the colonial era with Britain and the emergence of more multinational companies and institutions forcing the country into congruence with global equals. Hence, the Indian Companies Act of 1956 is a replication of the UK's Act though has been subjected to several changes to fit into the Indian context. Noteworthy is the amendment of 1965 and 1969 about the preparation of necessities for a cost audit. Similarly, of importance are two pronouncements issued in 1971 and 1973, which elaborated disclosure rules significantly (Perumpral *et al.*, 2009; Marston, 1986)

Prior studies in Indian context evaluate the relevance of the change in the accounting system to such a fast-changing economy like India. The findings of Rudras and Bhattacharjee (2011) and Gill *et al.*, (2013) revealed that earnings management is predominant in India. This thesis takes the research further by assessing India's earnings management over an extended number of years and evaluating how the adoption of IFRS might affect the degree of earnings management in India.

The institution of more liberal economic policies through an open economic system practised in India in the early 1990s has increased in a high dimension the inflow of foreign direct investment (FDI), technical and financial alliances of the country with the international community. This has impacted positively on the economy of the country, thereby making the country attractive to global investors. India has recently been adjudged one of the global fastest growing economies (Anderson and Lanen, 1999).

However, there still exists the trace of some 'traditional' accounting practices in the country. While investigating Indian managerial accounting practices, Anderson and Lanen (1999) argued that the influence of Indian government broadly inhibits the participation of investors and shareholders of Indian companies while developing their strategies. Takeovers and acquisitions and any other transaction perceived by the government not to be in the interest of the public or firms, are restricted by the Indian Company's Act. Despite the common modern accounting practice of consolidating the financial results of subsidiaries of group companies with their parent company, one can hardly find a financial statement presenting the operational result of a group company incorporating the financial results of both the parent and the subsidiary company. This is one of the major discrepancies of Indian Accounting standards with the International Accounting Standards. As observed by Fischer *et al.* (1993), the interest of shareholders fundamentally focuses on the general financial stand of

the company they invested in; the operational diversification of such company notwithstanding.

The need for change in Indian accounting practices seemed to have been triggered by the capital markets. It has come so quickly and with less political criticism (Echeverri-Gent, 2001). Nonetheless, business and evolution of the banking and business sectors are still engrossed in the custom and political intentions of the state parties. Also, the strength of the Indian cultural factor is an impediment to the convergence of its local accounting standards to the International accounting standard (Narayanaswamy, 1992). However, as at March 2007, according to the report of the Press Trust of India, India had embraced only 21 IAS contrary to 47 IAS as familiar with many developed countries (Press Trust of India, 2007). This motivated the ICAI council in July 2007 to publicise its plan on the convergence of the Indian Accounting Standards with the IFRS with effect from, April 1, 2011, but with a reservation of retaining Indian identity and incorporation of her settings in doing this (Deloitte, 2007).

This thesis of this section emphasises the essence and benefit from countries of emerging economic status to have some comparable financial reports with what is obtainable in the developed economies. Given the position of India as one of the leading industrial country, her adopting the IFRS will better position her in the global market and ultimately contribute to her economic growth.

Using discretionary accrual as the proxy for opportunistic earnings management, Rudra and Bhattacharge (2012) observe, against their expectation, a significant increased earnings management on adoption of IFRS in India (as in Leuz and Wysocki 2008 and Ball 2006). The inference from their study implies the ineffectiveness of IFRS to have a full grip on earnings management in India. According to Ball (2006), several reasons might have warranted this. He argues that managers

often resort to influencing the market prices of stocks when the liquidity of the capital market is not measuring up to that of emerging markets. Ball (2006) also emphasises the danger of using fair value as valuation model as they can be manipulated through their parameter by managers, and they can produce noisy and poor results. In the results from their control variables, firm's size does not significantly impact EM through discretionary accruals. The leverage ratio, though not statistically significant, indicates a positive direct relationship with earnings management.

Brazil and IFRS adoption

The evolution of Brazilian accounting standard began in the early '70s due to the restructuring of her financial system and growth of the capital market (Niyama and Silva, 2005). Shaped by the American accounting system, the reorganisation resulted in the segregation of tax rules from accounting rules in Brazil. Having the backing of the Central Bank, all Brazilian listed firms are required to publish their audited financial statements as audited by duly registered accountants. The Circular 178 and 179 issued by the Central Bank of Brazil (CBB) relates to the registration of Independent auditors/accountants and the Brazilian GAAP respectively. Subsequently, the GAAPs were implemented by the Federal Council of Accounting in line with the CFC Resolution 321-72. However, lack of clarity in these accounting principles led to its being offered in undergraduate education in Brazil, which was principally subject to the American accounting education (Niyama and Silva, 2005).

Through Resolution 220, the Brazilian Central Bank regulates the public listed firms and the independent auditor on the standard of financial reporting. However, the standards as issued via circular 179 mirrors American corporate financial reporting practice. The sections of standards described the bookkeeping standards, a measure of reserves and provision, criteria for measurement, presentation of the

income statement and balance sheet, depreciation and amortisation, among others. These ensure harmony in the reporting practice of Brazilian companies whether they have their shares traded on the stock exchange or not. Some amendments were later suggested by the Institute of Independent Auditors of Brazil (IBRACON) and were adopted by the Federal Council of Accounting. Most of the IBRACON independent auditors are from the large multinational American audit firms.

The economic shock experienced in Brazil in the mid-70s caused by increased oil prices and the change in the political ideology (military to democracy) has been advanced to be the source of motivation for more modifications to the regulation of accounting and auditing practice in Brazil. In further response to this, the Brazilian company law of 1976 was made. The enactment of the law, which is an adapted version of the Model Business Corporation Act of the USA, makes Brazil more American inclined as far as corporate regulation is concerned. The law came up with the hope of invigorating the capital market. The main features of the law are distinct segregation of business reporting from accounting for tax, and enhancement of balance sheet reporting, for example, reporting assets in liquidity order as practised in America. Asset revaluation at market value, adopting the equity method of valuation of financial investments and development of indexation methods are other features of the law (Rodrigues *et al.*, 2012). The application of this law impacted significantly on the Brazilian accounting system.

Brazil records a vast improvement in their financial reporting system on the enactment of the Companies law of 1976 than as recorded with the one issued in 1940. The law was also backed with enforcement enactment, law 6385, to regulate the stock market activities. This same law launched the Brazilian Securities and Exchange Commission. However, it shares many similarities with the law that backs the US

Securities and Exchange Commission (SEC). The Brazilian security and exchange commission oversees issues such as accounting standards, financial reports, management reports, required disclosures and frequency of disclosure, auditors' reports and many other issues regarding public listed companies.

There are two dimensions to Brazilian Accounting Standards: technical and professional aspect. While accounting concepts, rules and criteria are taken care of by the technical aspect, the professional aspect caters for guidelines towards professional conduct. Compliance with the standards was made mandatory, and failure to comply is punishable as a breach of ethical conduct. In a bid to harmonise the general Brazilian accounting principles, the law emphasised that the principle is called the fundamental principle and not generally accepted principles. This is the extension of the CFC Resolution 530-81 which made the principles mandatory. The principles relate to a business entity, classification and measurement of assets and liabilities, accrual principle, value measurement, periodicity, prudence, going concern and many more.

In the 80s, the economy of Brazil was struck by a high inflation rate, which scaled at 235% in 1984. In reaction to this, the constant purchasing power accounting method (CPPAM) was made compulsory for implementation by all public listed firms as a basis of preparation of additional financial statement that would reflect the inflation prevalent in the period. This injunction was made possible by CVM Instruction 64, as published in 1987. The instruction clarifies the fundamental basis for preparing financial statements in line with CPPAM requirements. This development contributes immensely to the improvement of accounting system in Brazil.

During the 90s, political instability ravaged Brazil. In 1989, President Fernando Collor de Mello's administration after the military era though short-lived, initiated privatisation of most government-owned

companies. He intended to encourage market-based reforms which require a great commitment. However, the inflation rate of his administration was very high. Hence the order to implement CPPAM demands that Accounting Monetary Unit (*Unidade Monetária Contábil* – UMC), with daily deviations, deduced, in the reported financial statement of Brazilian listed companies was made. The daily inflation adjustment was recommended so that the rate of inflation will adequately reflect the condition of the Brazilian economy. This further required that such daily adjusted figure, which is daily published by the National Association of Investment Banks be used in discounting the value of assets and liabilities of companies in getting their present values. Any gain or loss resulting from such conversion to present value is credited or debited to the income statement, respectively. This Brazilian system of adjusting the financial statement in reflection of the prevailing rate of inflation is globally recognised.

The study of Doupnik and Salter (1997) confirmed this. According to Doupnik (1986), argued that leading in financial reporting controversial issues, as far as the Brazilian economy is concerned, is the inflation accounting. This has witnessed three eras (pre-1964, 1964–1976, and 1976–1986) as far as Brazil is concerned. The impeachment of President Collor and emergence of Itamar Franco brought some structural changes to the country's fundamental accounting principles through the issue of resolution CFC 750 by the Brazilian Federal Council of Accounting. The new principles relate to a business entity, going concern, opportunity, record the original value at the transaction date, monetary correction, accrual principle and prudence (Rodrigues *et al.*, 2012). The directive recognised that the adjusting for inflation does not indicate new presentation and valuation, but about ensuring that original values at a given date are adjusted for inflation using the CPP of the domestic currency at the same period.

Through the intervention of the Finance minister, Fernando Henrique Cardoso that initiated Brazil's economic stabilization program (Plano Real), the Brazilian inflationary situation changed for better. The program launched a new non-monetary currency called *Unidade Real de Valor* (URV) which is approximately one dollar in value. This resulted in a great and rapid reduction in the inflation rate of the countries from 750% in the first half of 1994 to 18% in the second half. This gave Fernando Henrique Cardoso the goodwill of gaining re-election as President of Brazil on January 1, 1995, the position he retained until another president was re-elected in 2003. Further decrease in Inflation rate made the restatement (revaluation) requirement of the Federal government while reporting fixed asset and valuation of shareholders' equity to stop. This brought an end to the Brazilian school of monetary correction.

The Brazilian convergence with international standards started in 2005 when the CVM enacted Deliberation 488. The motives behind this development include promoting transparency and reliability of financial facts, reduced cost of capital especially those raised from global capital markets, and the fact that multinational companies will now need to prepare a single financial report thus duplication of effort of publishing financial reports under different standards would be avoided. Deliberation 488 also emphasised the essence of having comparable accounting entities. This made the first ten years of the 21st century a year of significant change in Brazilian financial reporting system. Subsequently, several modifications were made to the company law at different phases, which eventually led to the separation of Brazilian accounting and tax law. The implication of this is that different reports must be prepared to meet the requirements of the regulatory authorities as far as tax and financial accounts of companies are concerned.

To have proper enforcement back up the legislation, a committee of accounting pronouncements, called the *Comité de Pronunciamentos Contábeis* (CPC) in Brazilian language, was inaugurated by the Federal Council of Accounting on October 7, 2005. The committee was charged with the oversight of preparing and issuing technical guidelines that relate to disclosure and accounting procedures with a view of harmonising the local standards with the international standards. However, for the pronouncements, rules, and interpretations to be binding, all relevant entities alongside with the CFC have to endorse it. These entities are an association of listed companies, an association of capital market analysts and investment professionals, the federal council of accounting, Institute of Independent Auditors of Brazil, and the Institute for Research in Accounting, Finance and Actuarial Sciences. While acting in independent capacity, the CPC strives to involve Brazilian companies and regulatory groups in the international accounting convergence process, to ensure that the accounting standards issuance is from an entity as against the earlier many issuers and to ensure that all stakeholders (such as government, auditors, analysts, academics and other users of financial statement) are adequately represented.

The Central Bank of Brazil made the pronouncement in March 2006 that all entities under its supervision must publish their consolidated accounts based on IFRS by December 2010. The same step was adopted by the Brazilian Securities and Exchange Commission and the Brazilian Insurance Supervisor in 2007. The company law was also amended requiring all public listed firms as well as all large profit-making companies to adopt IFRS beginning from January 1, 2008. In 2007, the CPC, based on IASB's context, issued its first pronouncement on the Conceptual Framework for the Preparation and Presentation of Financial Statements. The convergence was necessary because of the increasing global economic and financial integration of Brazil made it necessary to improve the financial reporting of Brazilian corporations.

The evolution of Brazilian financial reporting has a strong bearing from its social, economic and political background. In the 20th century, Brazilian accounting system was greatly influenced by the European accounting system. As Brazil and USA increased their cross-border transactions in the 50s, American accounting model took over Brazil's. This led to two schools of thoughts: the Italian school of thought and American school. Most Brazilian accountants are proponents of the American school. They are often called the pragmatists. The Italian school of thought are supporters of the equity theory.

Currently, given the increasing global economic activities and a financial alliance of Brazil, the harmonising the national GAAP with IFRS has been adjudged to be of paramount importance and more relevant to both Brazilian companies and its economy. As observed by Shortridge and Smith (2009) the process might take time. The prior theory might need a retouch, and prior facts might necessitate re-evaluation. All Brazilian listed firms were mandated to prepare their financial statement in compliance with IFRS for financial years ending 31 December 2010. Authors have made their submissions on the impact of IFRS adoption on the quality of financial statements. Joia and Nakao *et al.* (2014) in their study found that the adoption of IFRS has not influenced the level discretionary accrual earnings management practised among Brazilian firms.

2.4 Review of IFRS adoption in Developed Economies

ITALY and IFRS Adoption

The Italian accounting regulator has always regulated the financial reporting system of the country based on the prudence concept and historical cost. Prior to the adoption of the IFRS in Italy, the provision of financial information as a basis for informed decision making is often a secondary one. The advent of IFRS, therefore, brought a significant change to the financial reporting system of the country. The standard

advocates for fair value accounting in preference to historical cost accounting. Also, emphasis on the value relevance of financial statements was made to discourage information asymmetry

Italy is particularly chosen for this study because it is one of the first time adopters with weak enforcement system, low quality of accounting standard, weak legal protection, poor investors' protection, and codified law system. The country also has good ownership concentration due to weak investor protection (La Porta *et al.*, 1998). Despite the transition to the international accounting standard, Durocher and Gendron (2011) argue that some countries still apply the standard to reflect their operational habits and were presenting their reports as close as if they were still reporting under their local GAAPs. Also, IFRS is prone to managers' influence due to the exercise of their discretions on accounting choices. Italy has been adjudged as one of such countries where the institutional background influences the efficacy of the IFRS in promoting the quality of reported earnings (Corbella *et al.*, 2013). Hence, Italy is included among the countries studied in this research.

In line with the Regulation (EC) No. 1606/2002, as issued by the European Parliament Council issued in 2002, the Italian regulator takes the bold step by ordering the public listed firms to prepare their consolidated financial statements in alignment with the IFRS. In response to this, the Italian government enacted Legislative Decree No. 38/2005. All listed firms whose financial instruments are traded publicly are mandated to prepare their consolidated accounts in congruence with the IFRS as of 2005.

Just after the EU pronouncement, a lot of academic debates ensued on the impact of IFRS adoption, especially when from the angle of the investors. According to Ball (2006), IFRS than the local standards are intended to:

- a) pay attention to the economic substance of a financial transaction more than its legal form
- b) recognise economic gains and losses promptly
- c) ensure that earnings are more informative
- d) provide a more reliable balance sheet;
- e) discourage the managers from manipulating the earnings through their discretionary instincts.

Ball (2006) further identifies how beneficial the adoption of the IFRS can be to the investors. These include the potential for more timely, accurate, and informative financial statements making the national standard inferior to the IFRS. Since financial statements drive financial information, tasks like valuation of equity, calculation of firms' cost of capital, and assessment of financial risks are made possible to financial analysts and learned investors. Furthermore, the financial statements are made comparable with that of firms in the EU. The IFRS enhances cross-border transactions, including acquisition and divestitures. Also, contracting between firms becomes easier as their financial information becomes comparable and transparent.

Although it is the intention of the Italian accounting regulator and IFRS to ensure that financial activities and economic performance of firms are reported truly and fairly. It has been empirically documented that such reports could be influenced by cultural and environmental factors (Corbella *et al.*, 2013). Unlike the local GAAP, IFRS encourages the use of the fair value in preference to the historical cost. It further classifies intangible assets to those having a definite and indefinite useful life. Also, IFRS makes provision for the impairment of assets. Financial leases are reported based on acquirer's financial commitment. It recommends that share-based payments are recognised in the income statement and that employee's benefits should be calculated using the

actuarial method. This difference that IFRS adoption brought has greatly impacted on the financial reporting system in Italy. Therefore, earnings quality is expected to increase as promised by the IASB. Conversely, some firms might use this as an opportunity to practice earnings management due to the uniqueness of the standard as it affects accounting practices.

France and IFRS adoption

France is one of the EU member countries that implemented the directive of the EU; that from 2005, all listed firms should apply the IFRS in preparing their consolidated financial statements. This directive excludes firms listed on the *Alternext*, and it does not apply to individual accounts. Therefore, the non-listed firms in France have the option of reporting their consolidated financial statements based on the IFRS or French accounting regulations. Nevertheless, French local GAAP is still vital to its financial reporting system.

The financial reporting system in France is anchored on the Commercial Code. The Code is subject to regular review and amendments by the parliament or ministerial orders. Its administration remains the sole responsibility of the government. On this premise, the EU's directive on IFRS adoption automatically became Commercial Code by a decree in France. Although the Commercial Code gives no comprehensive explanation of all accounting requirements, the accounting standard authority, *Autorité des normes comptables*, (ANC) demystifies the accounting requirements of the Commercial Code in a more detailed manner. In line with this, the ANC issued two major documents: regulations for consolidated accounts (relating to the Banking sector, industrial and commercial firms) and the French General Accounting Plan (*Plan comptable général*, PCG for individual accounts).

Accounting rules guiding the financial reporting of individual accounts and consolidated accounts in France differ. In France, the legal and tax issues have a strong influence on individual accounts, unlike in consolidated accounts of group companies. This is because group companies lack legal or tax status in France. The regulations CRC-99-02 and 99-07 on consolidated accounts issued in 1999, makes the French GAAP considerably similar to the IFRS, though some differences still exist (Delvaille *et al.*, 2005).

Before the ANC was the CNC (*Conseil National de la Comptabilité*). This forerunner of ANC foresaw the complexity of reporting in two different accounting standards (French GAAP and IFRS) in the future. In 1999, the CNC attempted to harmonise the PCG with the IFRS. Two teams were formed to investigate whether IFRS can apply to individual accounts or not. The groups are the IAS and Law group and the IAS and Tax group. While the objective of the former is to evaluate the implication of IFRS adoption on French law, the latter was to determine the effect of IFRS adoption on taxes emanating from individual accounts. The two groups came out with their recommendation in 2005 that individual accounts might consider reporting in IFRS due to the potential benefits of its application.

The literature documents academic debates on the contribution of IFRS adoption to the 2007 financial crisis in France. Some authors argued that IFRS adoption worsened the crisis (Burlaud and Colasse, 2011; Marteau and Morand, 2010). However, Baert and Yanno (2009) argue that there is no significant evidence of discounting the IFRS for the French GAAP. They instead agitate for fast-tracked harmonisation French accounting regulations with the IFRS.

Adoption of IFRS in France has been criticised for lacking a formal and systematic consultation of the stakeholders (Anne, 2017). Some view the EU accounting directive as government imposition. However, the

ANC considered this in their membership composition. Stakeholders are largely represented in the regulatory body; as they are made up of accounting professionals, investors, academics, legal practitioners, and government representatives. Also, the ANC also offers to advise on legal and provisions of the regulators concerning accounting measures. It can, therefore, be assumed that the stakeholders are involved in the implementation process of the IFRS adoption in France.

Germany and IFRS adoption

The internationalisation of financial reporting in Germany started in the early 1990s as motivated by companies of global reputations such as Daimler Benz AG, BASF AG or Bayer AG. These companies are dominant players in production, distribution and financing activities in Europe, Asia and North America. This further buttresses the cross-border listing of German firms on international capital markets. Further to this, while some listed German firms tried to be more transparent to their shareholders, the increasing shareholder value orientation necessitates that such firms report their financial activities based on the International Accounting Standards (IAS) for a comprehensive disclosure. These companies adopted the IAS voluntarily in preparing their consolidated financial reports.

The pre-adoption of IFRS period in Germany is characterised by porous accounting system whereby firms are permitted to report their financial statements on the IAS, the German GAAP or US GAAP. Hence, the financial performance of companies can only be done across similar firms; however, the difference in the standards used for reporting can make a comparison of non-similar and non-German based companies' complex. However, the firms that adopted the standard voluntarily had to prepare their consolidated accounts both in German GAAP and in line with the IAS at the same time. This led to German's financial reporting system having two strategic features: 1) consolidated financial reports prepared by the few US-cross listed firms, based on

German-GAAP with reconciliation (this is also called parallel accounting), and 2) double financial reporting, both in German-GAAP and IAS (Pellens, 1997). Furthermore, the financial reporting system in Germany is a stakeholder-oriented system. It also shares significant similarity with the country's tax rules. The German GAAP permits only historical cost accounting method of reporting.

Having evaluated the attitude of German managers towards the adoption of the international standards, Glaum (2000) finds that the managers are keen to imbibe the change as the standards are perceived to be more value relevant. Nevertheless, this does not exclude the scepticism of some German managers on their choice of reporting in IAS or US-GAAP. Hence, this attitude stimulates short-term thinking as well as affecting the capital markets adversely (Glaum and Mandler, 1996). No prior empirical research negates this argument.

As a result of the increased lobbying of the German IAS- and US-GAAP inclined firms, the German government came up with two main acts in 1998: The German Capital Raising Facilitation Act and the Corporate Sector Supervision and Transparency Act. The latter include a cash flow statement, statement of owner's equity and segment reporting in the consolidated financial statements of public listed firms, gives legal backing to the private German standard-setting body, an output of the German code law practice. The former, however, provides an option of preparing consolidated financial statements based on IAS, US-GAAP or German-GAAP as if they were cross-border listed. This implies that IAS- and US-GAAP compliant firms were exempted from reporting their consolidation activities in the local standards. This increased the number of firms that adopted IAS. By 2001 almost 36 % and 29% of German firms report their financial activities based on IAS and US-GAAP respectively (Zwirner, 2010).

In pursuit of the EU initiative toward the internationalisation of accounting, German firms were also made adoption of the IFRS mandatorily adopt in 2005. Each member countries is obliged to prepare their annual consolidated accounts in line with IFRS. The listed firms are mandated to prepare their financial report using the IFRS while the non-listed firms have the options of applying the German GAAP or IFRS. Nevertheless, the German regulator discourages reporting in single financial statements hence the need to prepare financial statement based on the German GAAP to the legal and fiscal implications of the financial statements. The IFRS prepared accounts are for comprehensive disclosure purposes only (Haller and Eierle, 2004).

Adoption of IFRS in Germany in the last two decades has increasingly influenced her capital market and financial reporting system. However, this argument has been empirically contested due to the diversity in the institutional setting of the reporting firms. Consistent with this, prior cross-country studies, significant dissimilarities exist in the economic implications of reporting in IFRS at firm and country level (Daske *et al.*, 2008). Although the emphasis was placed on valuation, culture has also been found to be an influencing factor (Nobes, 2006).

Apart from capital markets influences, the differences might also increase due to the weight of the contractual considerations (Coppens and Peek, 2005; Burgstahler *et al.*, 2006; Peek *et al.*, 2010; Fülbier and Gassen, 2010). The internationalisation of German accounting practice and regulation has a major influence on consolidated financial statements of her reporting firms. However, in the 1990s, the regulatory authority preserves the commercial law accounting custom of reporting on the single financial statement while not ignoring their compliance to the EU regulation 1606/2002 in 2004 (Haller and Eierle, 2004).

Also, German stock exchange listing requirements allow non-German accounting systems. This incites the fear of negative consequences on

the preparers and their managers (Glaum and Mandler, 1996). The single financial statements system was still guided by the HGB (Handelsgesetzbuch) to preserve the contracting consequences of Germany firms and her valuation oriented accounting practices. This enables all German firms to meet their contractual requirements continuously with data from the single financial statement.

In the context of this study, there is a need to review prior study on IFRS adoption and the quality of financial reporting in Germany. While examining some German firms on the impact of voluntary adoption of IFRS on earnings management, Tendenloo and Vanstraelen (2005) find that that only firms audited by the Big-4, have a significant reduction in their earnings management. They conclude that the adoption of IFRS is not sufficient to guarantee a better quality of financial reporting. However, Guenther *et al.* (2009), having studied a large sample of German firms for the period of 1998 to 2008, observe reduced discretionary accruals after the mandatory adoption of IFRS. Furthermore, Harris *et al.* (1994) argue that the earnings of firms in Germany are not ‘managed’ as popularly alleged because they are closely related to the stock price and returns. They also argue that the earnings to stock market return association in Germany is closely related to that of the US.

Conversely, the literature documents a reduction in information asymmetry among German firms that voluntarily adopt the international accounting standard under the two reporting strategies above (Leuz and Verrechia, 2000). Other studies on the influence of the international accounting standard that was done on Germany include Bartov *et al.* (2005), Daske *et al.* (2007), Christensen *et al.* (2015),

Australia and IFRS adoption

Although Australian authority allowed voluntary adoption of the IFRS standard, the mandatory adoption in January 2005 did not come as a

shock to companies in the country. About 1% of the listed companies adopted the standards on the voluntary note before 2005 (De George *et al.* (2016). The unique feature of IFRS adoption in Australia is that all companies, whether listed or unlisted, were mandated to adopt IFRS by January 1, 2005. Hence, firms were not given the option of reporting in other accounting standards. Studying the country around IFRS adoption gives a platform for testing the effect of IFRS adoption on private firms and the economy as a whole.

Research evidence on the impact of IFRS adoption on financial statement quality of Australian firms abound. However, empirical findings of research concerning the adoption of IFRS in Australia are inconclusive and mixed (Pawsey, 2016). Having reviewed 19 papers, mixed results have been attributed to variance in the measure of financial statement quality and how samples are chosen. The sampling problem is traceable to results of voluntary adopters of IFRS. Firms that adopted IFRS voluntarily might not be a good representation of the population of the study. In addition to this, controlling for motives and other market-related factors will be difficult (Chua and Taylor, 2008; Pope and McLeay, 2011).

Several authors have explored, using different research methods, whether earnings management reduced on the adoption of IFRS in Australia or not. Studying irregularities in the distribution of earnings among 1,146 firms (including Australian, France and UK firms) for a study period between 2002 and 2009, Jeanjean and Stolowy (2008) observe an abnormally low number of small losses while the number of small profits is unusually high among the Australian firms. In their bid to assess the impact of the adoption of IFRS to the propensity of firms to manage earnings and avoid losses, their assessment of income published by the 422 Australian firms studied reveal a stable earnings management under IFRS just like that of their GAAP. Having examined 172 listed firms, Chua *et al.* (2012) examine among others

pervasiveness of earnings management pre and post IFRS adoption focusing on the degree of earnings smoothing and the tendency of managers to be managing earnings towards a definite target. They find that the quality of financial statement improved post adoption of IFRS through fewer earnings management and income smoothing. Other studies of the international accounting standards conducted in Australian setting include Jones and Higgins (2006), Cheung *et al.* (2008), Chalmers, Clinch, and Godfrey (2011), De George *et al.* (2013), and Lai *et al.* (2013).

UK and IFRS adoption

The United Kingdom was a member of the European Union before the Brexit in 2016. As unanimously agreed that all listed companies in the economic region should prepare their consolidated financial statement based on IFRS by January 1, 2015, public listed firms in the United Kingdom has to obey the mandatory injunction. The literature ascribes higher information quality as one of the dividends of reporting under the new standards. Also, the IASB expected that IFRS would promote transparency and comparability of financial statement prepared on it basis among adopting firms in order to ensure that users are equipped with adequate accounting information for improved decisions (EC Regulation No. 1606/2002).

The UK, unlike other European countries, did not allow early adoption of the IFRS. This is an avenue for a smooth study on the effect of IFRS adoption on UK firms with the result of not being impaired by the inclusion of firms that adopted the standards voluntarily. Apart from the US, the UK has enough market and accounting data of listed firms, hence the opportunity of getting a large sample from the UK. Hence, the UK is well represented in this study. As an active investor protection country, the UK has its original GAAPs shared most similarities with the IFRS because they were using the IAS standards as the basis of

financial reporting before 2005 conform highly to IFRS adoption (Xu, 2014; Haller, 2002).

Nevertheless, there are some differences between the versions of the standards. As emphasised by Horton and Serafeim (2009), the dichotomy between the UK IAS earlier used before 2005 and the IFRS standard can be classified into six: the goodwill, employee's benefits, share-based payments, taxation, leases, employee benefits and financial instruments. Furthermore, IFRS as a principles-based standard allows the exercise of professional judgement than the rule-based UK GAAP (Nobes, 2006). A good example is the treatment of Goodwill; while IFRS wants its impairment to be assessed yearly, the UK GAAP wants it amortised.

The principle-based standards allow managerial discretions, which may result in the manipulation of accounting figures through their decisions in influencing the reported earnings figures. Callao (2010) posited IFRS could encourage higher flexibility while the standards are being interpreted for application, and this might lead to a higher level of earnings management. As supported by Iatridis and Joseph (2005), there is the tendency of having increased income smoothing on the application of IFRS. In the opinion of Ball (2006), fair value accounting as promoted by IFRS could lead to opportunistic earnings management.

Also, the findings of Heemskerk *et al.*, (2006) emphasised that although IFRS appears strict, its operationalisation attracts great exercise of managerial discretions. Hence, the expectation of having improved financial reporting quality on adoption of the new standards may be unrealistic. In line with this, Soderstorm *et al.* (2007) warns against making an 'umbrella' conclusion on whether IFRS adoption promotes the quality of financial statement or not. Other studies conducted on the UK setting include Panaretou *et al.* (2013), Brochet *et al.* (2013), Christensen and Nikolaev (2013) and Liang and Riedl (2014).

2.5 Earnings Management and Cross-Country Differences

Apart from the study carried out by Leuz *et al.* (2003), there is a dearth of research evidence treating the level of earnings management across countries. Leuz *et al.* (2003) classified 31 countries into groups in order to study the degree of earnings smoothing practised among them. In their explanation, Leuz *et al.* (2003) established that insiders tend to manage earnings to protect their controlling interest and guide against external interferences. Insiders use accounting discretion in the bloom period by understating earnings through the creation of hidden reserves that could be used in the gloom period to smooth earnings.

Further, the institutional features used as the basis for classification include ownership structure, capital market development, legal system and investor protection. Their findings disclose that companies in the insider-oriented economies, such as Germany, characterised by a less developed stock market, weak investor protection and concentrated ownership structure indulge in earnings smoothing more than their counterparts in outsider-oriented economies. The reason for this is attributed to the dispersed ownership structure, developed stock market and better investor protection identified with the latter economy. In support of this, Haw *et al.* (2004) discovered that the undisclosed level of discretionary accruals reduces in countries having high investor protection and robust enforcement in comparison to other countries.

Evidence also exists in the literature about how differences in institutional environments could influence earnings management behaviour between public listed and privately-owned firms. According to Burgstahler *et al.* (2006), privately-owned firms practice more earnings management than publicly owned firms. On this premise, the institutional frameworks and their discrepancies are found to be the influencing factors on the degree of earnings management found among countries. According to them, investor protection, book-tax

configuration, capital market structure and firm ownership affect earnings management behaviour. Gunther (2011) also supported that ownership structure could be one of the essential factors of earnings characteristics in Germany and countries having similar institutional frameworks. However, Leuz *et al.* (2003) do not precisely analyse the effect of ownership structure on the earnings management of the companies studied.

This study argues that earnings management is a universal phenomenon despite the diversity in the institutional framework of countries. It also acknowledges the on-going popularity of the IFRS. However, there is a dearth in the literature on the influence of institutional frameworks on the extent of earnings management. Further, how the adoption of IFRS has influenced earnings management among countries, considering their institutional diversities is understudied.

2.6 Summary

This section reviews the institutional background to IFRS adoption. Prior to the emergence of the IFRS, each country has its way of regulating its financial reporting system, especially through their local GAAP. Given the promises of the IASB on IFRS and the support of the international organisations towards its adoption, countries see the adoption of IFRS as a necessity. However, structural adjustments to their financial reporting system will be necessary before subscription to the IFRS and after the adoption of the standards. Hence, this section reviewed how the IFRS evolved among the countries studied. The next chapter reviews the literature on IFRS and how it has influenced the quality of reported earnings among countries based on their institutional setting.

Chapter Three: Literature Review.

3.0 Introduction

This chapter reviews prior studies on the core variables of study earnings management and the IFRS. This provides a platform for addressing the research questions. The chapter starts by discussing the context of the study, IFRS and globalisation in the context of political and economic capitalism, the concept of earnings quality, earnings management and its measures. It further explores the relevance of IFRS adoption to earnings management and value relevance. It goes further to discuss the theoretical framework, factors influencing the adoption of international accounting standards and the interaction between IFRS adoption and quality of financial reporting, IFRS adoption and emerging economies and the role of the Big Four concerning earnings management and IFRS adoption.

3.1 Context of the Study

The forces of change emanating from globalisation soon revealed the ineffectiveness of individual countries' GAAP in coping with the global financial reporting challenge. Before the advent of IFRS, corporate reporting was mostly influenced by local standards and the regulations of the countries in which the reporting firms were domiciled. The interest in published financial statements of companies is no longer limited to the reporting entities and their local investors. Other firms and investors beyond the reporting firm's vicinity are also interested in their financial reports. This makes international corporate reporting (accounting) more relevant than corporate reporting, especially in the current era.

Global financial crises originated from the United States of America (USA). Due to the strength of its influence on the global economic system, especially capital markets, it affected other countries. This

provoked the initiative of the IASB on the uniform standard, IFRS as earlier explained in chapter one. Though the USA still maintains her US-GAAP, adoption of IFRS has spread beyond the territory of the European Union as most countries have or are in the process of subscribing to it. This research acknowledges the two major standards - the IFRS and the US-GAAP - as having a strong influence on international corporate reporting. However, it focuses on the IFRS (due to its prominence) in evaluating the differential impact of IFRS adoption over local GAAPs on earnings management. Unlike prior studies, I controlled for the institutional and economic features of adopting countries.

Since core information investors and other users of financial information are interested in assessing the viability and stability of companies by their profits, managers often engage in earnings management⁷. This research empirically tests the extent of earnings management before and after the IFRS. Given the claim that IFRS is a high-quality standard, a question remained unanswered in accounting research. Can IFRS adoption reduce the level of earnings management?

Further to the discussion above, Figure 2.1 pictorially illustrates how corporate reporting converts to international corporate reporting through the inevitability of the forces of change resulting from economic meltdown and globalisation.

⁷ For the purpose of this chapter, earning management is a behavioural attitude of managers to present reported earnings of their companies in line with their goals.

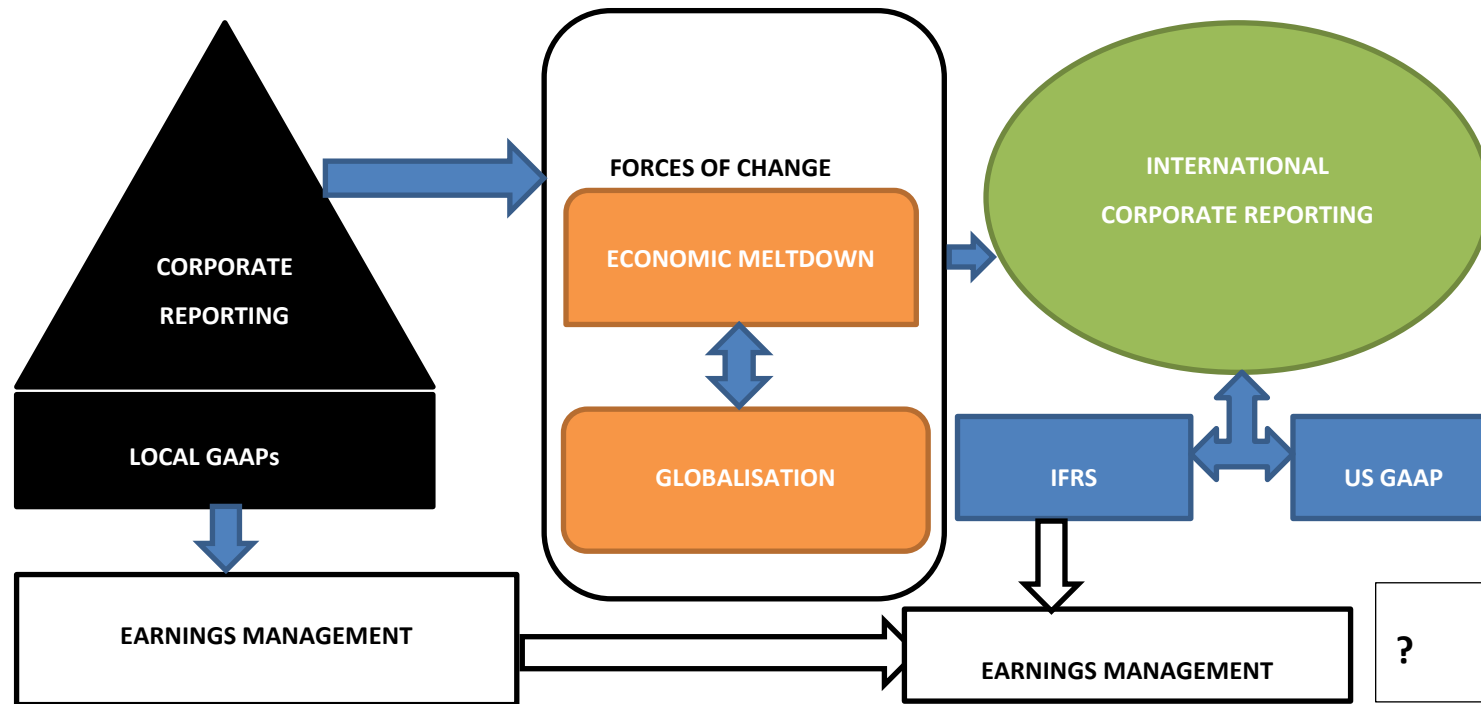


Fig2.1: Corporate Reporting before and after the Adoption of IFRS and the Influence on Earnings Management.
Source: Author's Composition

3.1.1 Globalisation and Evolution of International Accounting Standard

The concept of globalisation is popular and has often been used in complex critical discussions in the literature. However, the procedures that symbolise global interconnectivity are often undermined (El-Ojeili and Hayden, 2006). Globalisation came about due to the collapse of the eastern socialist bloc. Due to the dominant role played by the US during the cold world in the early 90s and as a matter of necessity the capital market became internationalised, thereby resulting in the globalisation of the social and economic structures that uphold it (Kouroundis, 2007).

Various authors have defined the concept of globalisation in economic, political and social contexts. Mann (2001) defined globalisation as an extension of social relations on a global scale. Although this definition, in its social context, provides a broad conceptualisation of globalisation, Giddens (1990) defines it more distinctively. According to Giddens (1990), globalisation is *'the intensification of worldwide social relations which link distant localities in such a way that local happenings are shaped by events occurring many miles away and vice versa'*. Furthermore, Mantzari (2013) defined globalisation as a process that connotes both the compression of the world and the intensification of consciousness of the world as a whole. In the same vein, McGrew and Held (2002) viewed globalisation as *'the expanding scale, growing magnitude, speeding up and deepening impact of interregional flows and patterns of social interaction. It refers to shift or transformation in the scale of a human social organisation that links remote communities and expands the reach of power relations across the world's major regions and continents'*.

Based on these definitions, globalisation is not just about unbiased consideration of increasing global interconnectedness. Subjective issues relating to the density of the consciousness of the world as a single entity should also be considered. The globalisation theory also

relates the linkage between density, velocity and diffusion to globalisation (Held *et al.*, 1999). Furthermore, Harvey (1989) argued that globalisation has dimensional implications because of the extent of the interdependence among countries often spread globally.

The extant literature documents globalisation in other contexts such as education, culture, religion, politics and terrorism. While acknowledging the interrelatedness of these concepts, this research focuses on the economic and political dimension of globalisation. Academic debates on economic globalisation have a strong linkage with *neo-liberalism*, commonly perceived to be capitalism at its new stage. Due to the essential contribution of economic globalisation to the global financial reporting system, the subsequent paragraphs discuss these concepts further.

3.1.2 The Myths and Realities of Economic Globalisation:

Based on capitalism theory, improvements in the international economy, politics and the preference for neo-liberal dogmas brought about globalisation (Barrett, 1991). Governments using *neoliberalism* often refer to globalisation as a rhetoric mechanism to justify their decisions, especially when their policies are not favourable to the welfare of the state (Kouroundis, 2007; Mantzari, 2013). Having noted the general perception of globalisation as a phenomenon beyond human control or as the justification of everything arising from the process, Bauman (1998) concludes that global capitalism is inevitable. As advanced by Fukuyama (1992), liberal democracy and market capitalism are essential for an effective global economy. He also added that capitalism is the real destination of ideology and the conclusion of history.

The proponents of globalisation advocate their opinion of the likelihood of countries benefiting tremendously, especially around international competitiveness (Mittelman, 2000; Burbach, 2001). The rise in the

number of multinational companies (MNCs) has also been documented in the literature to promote globalisation. Their motivation towards profit maximisation, cost reduction and exploration of new markets for their products and services will challenge them to engage in global competition and production at international standards while geographical borders become irrelevant (Dichen, 1998). The necessity of promoting capital movement across international borders has also led to the establishment of many international organisations and financial institutions such as the World Bank, the International Monetary Fund (IMF), the World Trade Organisation (WTO) and the G8 acting at multi-national levels (Rosenau, 1997).

Globalisation has made local laws and regulations seem inferior to international laws. In some cases, these local laws and regulations are compromised, and this has resulted in a paradigm shift. Governments of countries graduated from being mere national regulators of political power and flow of capital into actors with international dimensions by interacting with regulations beyond their territories that influence their economic and political systems (Lash and Urry, 1994; Ohmae, 1995; Beck, 2000).

Conversely, economists and academics have critically debated the notion of globalisation as a new system of capitalism (Mann, 1993; Hirst and Thompson, 1999). They acknowledge the current position of industrialised countries and their influence on global economic dealings and governance (Arnold and Sikka, 2001). However, the link between capital and state was misconceived (Woods, 2000). There was a failure to recognise capital as a social development; instead, the emphasis was placed on the integration and interaction of countries. For instance, in 2009, the G20 replaced the G8 as the main economic community of wealthy nations, which includes other major countries that are of emerging status. Modern economic developments and the activities of countries are viewed as unbiased social developments rather than

differentiated social benefits, where governments institute a platform for the exhibition of political power and the propagation of a dominant system (Sakellaropoulos, 2009).

3.1.3 IFRS and Globalisation

The EU's initiative of developing an active, unified market and enhanced accounting practices since globalisation evolved has significantly influenced global accounting systems by promoting internationalisation. Also, the integration of the financial market of the EU, the upsurge in the internationalisation of businesses and influence of international audit firms put the global financial reporting system under pressure (Hopwood, 1994; Mantzari, 2013). According to Hoogervorst (2012), as far as raising capital is concerned, geographical boundaries are no longer a barrier. All investors look for opportunities in global capital markets. In order to avoid duplication of effort and increased reporting costs, multinational corporations want a single published annual report based on a uniform standard to cover all their international activities. However, this may conflict with what regional policymakers such as national governments and professional accounting bodies want.

Globalisation has challenged the relevance of national accounting standards to contemporary financial reporting. Dwelling on national accounting standards has been criticised as a limitation to the smooth running of global financial markets. This accounts for the strong support of the G20 for the move of the IASB and emphasis on the need for an immediate transition to international financial reporting standards. This further brought about the establishment of an institution like the IASB to regulate the accounting profession and represent and develop measures that will pursue their members' interests and rationales, including policy-making both locally and internationally. These advances have been argued to have led to the famed globalisation, the norm of our times (Weiss, 2000). Hence

harmonisation of international financial reporting, the increased popularity of IFRS and their links with globalisation are popular issues of discourse in accounting research (Gallhofer and Haslam, 2006; Diaconu, 2007; Mantzari, 2013; Chand and Patel, 2008). Further to this, considering the evolution of global financial reporting systems in confinement to national and EU contexts without considering its influence on the political and macroeconomic variables in broader economic power shifts as related to the entire world, will give an inadequate picture of the scenario.

3.2 Concept of Accounting Earnings Quality

The IFRS framework recommends that companies should adopt the Conceptual Framework for Financial Reporting of the IASB because it contains a comprehensive discourse of the qualitative features of financial reporting information as useful to its users (Pascan and Neag, 2013). Due to this, the IFRS Framework serves as a fundamental source of the definition of accounting earnings quality. Financial information is valuable if it can adequately reflect the actual economic realities of the reporting firm. Accounting information is said to be useful if it is comparable, reliable, timely and understandable (Pascan, 2015). While the reliability of financial statements has been variously tested by scholars using various dimensions, the area of comparability is the least researched.

As driven by the influence of globalisation on the accountancy profession, reporting firms are not just reporting to users of financial statements in their various countries but all over the world, and especially to global investors. Comparability in this context is when the financial statements, as published by a firm domiciled in a country, have a uniform basis of evaluation with another firm in another country. While adoption of IFRS has been argued in the literature to facilitate this, the situational and environmental factors of the countries of

reporting firms might mitigate against the reliability of the published financial statements.

According to Martinez-Ferrero (2014), financial reporting quality is the truthfulness of the information published by the financial reporting process. Companies must make adequate disclosure of relevant financial information as needed by users for informed decision making. However, Chen *et al.* (2010) define accounting quality as the magnitude at which the financial statement information mirrors the underlying economic situation of the reporting firm. In addition to this, Platikanova and Perramon (2012) argue that the ability of users to recognise the similarities and differences between two sets of economic phenomena is when they perceive the accounting information to be of higher quality. This is consistent with the objective of IASB to eliminate accounting information asymmetry among reporting entities. In this context, financial statements are viewed to be of high-quality if prepared based on a quality standard with reduced earnings management; so that such accounts can be reliably used for decision making (Beest *et al.*, 2009; Palea, 2013).

The quality of the standards chosen is often referred to in the literature from the perspective of the “distance” between the local GAAP and the IFRS. As argued by Ahmed *et al.* (2013), IFRS as a quality standard stands a better chance of improving accounting quality than local standards if they are appropriately enforced. Furthermore, a higher quality standard should potentially include the managerial exercise of discretion on accounting choices and intrinsically discourage earnings smoothing or overstatement. However, Narktabtee and Patpanichchot (2011b) argued that country and firm characteristics influencing reporting incentives also serve as a basis for improved accounting quality. For instance, firms operating in a weak investor protection country and that are under the administration of managers who have a high tendency to indulge in earnings management might have the value

relevance from IFRS adoption compromised. Conversely, financial reporting quality might still be circumvented by managers based on one motive or the other, even when the high-quality standard is used, and such firms operate in a country with substantial investors' protection.

3.2.1 Influencing Factors to Accounting Earnings Quality.

The nature of IFRS adoption, mandatory or voluntary, has been established as an influencing factor in accounting quality. Pascan (2015) opines that the diversity in research results might be a result of the nature of the adoption of IFRS, i.e. voluntary or mandatory. Also, Christensen *et al.* (2008) argued that the results of IFRS adoption on accounting quality are often dependent on the motives behind the decision for adoption. Based on this, the quality of reported earnings is likely to be influenced by managerial motives for reporting rather than the mere application of the standards.

The literature establishes various determinants that could clarify the results derived while testing for the impact of IFRS adoption on accounting quality. Soderstrom and Sun (2007) and Houque *et al.* (2012) highlighted three factors that can influence accounting quality on IFRS adoption:

- (a) the quality of the standards;
- (b) the legal and political system of the country; and
- (c) the motive for financial reporting, e.g. financial market development, capital and ownership structure and tax system.

In line with this, this thesis acknowledges and adopts the three factors, but places a high emphasis on the first two. Consistent with the literature, the quality of financial reporting standards is measured as the difference between financial statements prepared using a country's local standards and that of the IAS/IFRS, on the assumption that

accounts prepared are devoid of earnings management. Earnings management is used as a proxy for accounting quality throughout this thesis. Lower earnings management depicts a higher quality of reported earnings. This is further elucidated in subsequent chapters.

3.2.2 Measures of Accounting Earnings Quality

This section discusses the various types of earnings quality, as evidenced in the literature. Although accounting and financial economics literature establishes the essence of earnings quality, there is no universal definition of it; neither does it have a single measurement index. It has various faces in the literature, including but not limited to the following: earnings persistence, predictability, asymmetric loss recognition, benchmark beating, earnings smoothing, magnitude of accruals, income increasing accruals, absolute value of discretionary or abnormal accruals and the extent to which accruals map into cash flows (Dichev *et al.*, 2013). Due to this, it is difficult to establish from the literature a reasonable percentage of earnings management even from the earnings process (Dechow *et al.*, 2010).

Therefore, determining the appropriate measure of accounting earnings quality depends on the specific stakeholder that authors are addressing and the perception of the users (e.g. investors, lenders and other creditors) on the usefulness of the financial statements. For review purposes, this thesis appreciates and reviews various metrics used in measuring accounting quality by prior researchers. These are considered below:

(a) The value relevance approach

A published financial statement can be adjudged to be value relevant if the financial information it portrays captures and reflects the value of the reporting entity. In the words of Kargin (2013), the value relevance

of financial statements can be measured through the statistical associations between the information presented by them on their stock market values and returns. Much work has been done on value relevance as a measure for evaluating the effects of IFRS adoption on the quality of accounting data. The possible justification for the popularity of this measure lies in its being investor-focused. The value relevance measure creates an avenue for evaluating the extent to which financial statements prepared based on IFRS adequately reflect the reporting firm through the value of their market share prices (Lenormand and Touchais, 2009).

(b) The credit relevance approach

In response to demands for financial reporting from parties other than stock market investors, other metrics for measuring accounting quality have been developed by researchers to provide an excellent platform for assessing the specific information needs of users (Soderstrom and Sun, 2007). Evidence exists in the literature on the importance of credit relevance concepts in assessing the differences between published financial reports before and after the adoption of IFRS. According to Kolsi (2010), credit relevance is “*the relative ability of accounting risk measures to explain default probability captured by S and P's issuer credit ratings*”. Credit relevance addresses the specific needs of lenders and other creditors. In this direction, Kolsi (2010) empirically investigated the extent of sensitivity of credit ratings to the profitability, leverage and interest coverage ratio of published financial statements under the IFRS system and those under local standards.

The enhanced disclosure that IFRS encourages ought to improve the credit relevance of accounting information of a firm. Having studied the implications of IFRS adoption on accounting information, especially cost of debt among EU firms, Moscariello *et al.* (2014) discover a strong relationship between IFRS adoption and the cost of corporate

debt. They argue that the inherent risk causes the increased cost of debt due to insufficient information regarding the company. Hence, lenders often bridge this gap by charging an interest rate that best compensates for the information and economic risk relating to the borrower (Moscariello *et al.*, 2014).

(c) Timely loss recognition approach

Some researchers have also investigated earnings management through timely loss recognition (Christensen *et al.*, 2008; Paanamen and Lin, 2009; Chen *et al.*, 2010; Liu *et al.*, 2011; Zeghal *et al.*, 2012; Uyar, 2013 and Ahmed *et al.*, 2013). Timely loss recognition emphasises that losses should be recognised at the period of their occurrence rather than being spread out over some periods to practice earnings management (Ball *et al.*, 2000; Liu *et al.*, 2011).

3.2.3 Reservations on Accounting Earnings Quality Measures

Although the afore-mentioned earning quality measures are in congruence with what has been advocated by earlier researchers (for instance, Leuz *et al.*, 2003; Barth *et al.*, 2008), they are not without their flaws. Initially, accounting numbers proxies, for instance, earnings management, are not only influenced by fundamental economic factors and the exercise of managerial discretion but of greater relevance are the accounting standards based on which they are prepared. The IFRS, for example, allows that development expenditures incurred during the period of local standards be capitalised. The resultant effect of this is that earnings will increase while volatility will reduce. Likewise, IFRS advocates goodwill impairment in preference to regular amortisation. Implementation of this will result in an escalation of accruals and earnings. The only exception to this is when impairment of goodwill occurs.

Also, unrecognised employees' benefit expenses before the adoption of IFRS might generate a significant impact on the number of accruals. The implication of this is that accrual will reduce just as earnings do, but that there is a tendency towards smoothing. The primary issue is that while implementing some accounting standards, there is the possibility of making alterations to earnings items without affecting the quality of accounting earnings. In line with prior studies, this thesis assumes that variation in the quality of earnings measures used is a direct function of the change in the earnings quality (Leuz *et al.*, 2003 and Burgstahler *et al.*, 2006; Ahmed *et al.*, 2013). However, as far as possible, these limitations were ameliorated by using different measures of earnings management as a measure of earnings quality. The reason behind this is that, although the accounting standards in use may affect some of the measures of earnings quality used, the probability that adoption of IFRS will impact equally on all metrics used in measuring the earnings quality is narrow.

Furthermore, while acknowledging how versed the concept of earning quality is, using earnings management as a proxy for its measure may not present the totality of earnings quality. For instance, EM measures may not capture the accounting figures relating consolidation of an entity shown in their footnote. The diagram in fig. 2.2 below pictorially illustrates the earnings quality measure from the broader perspective in the context of the literature to a narrow view.

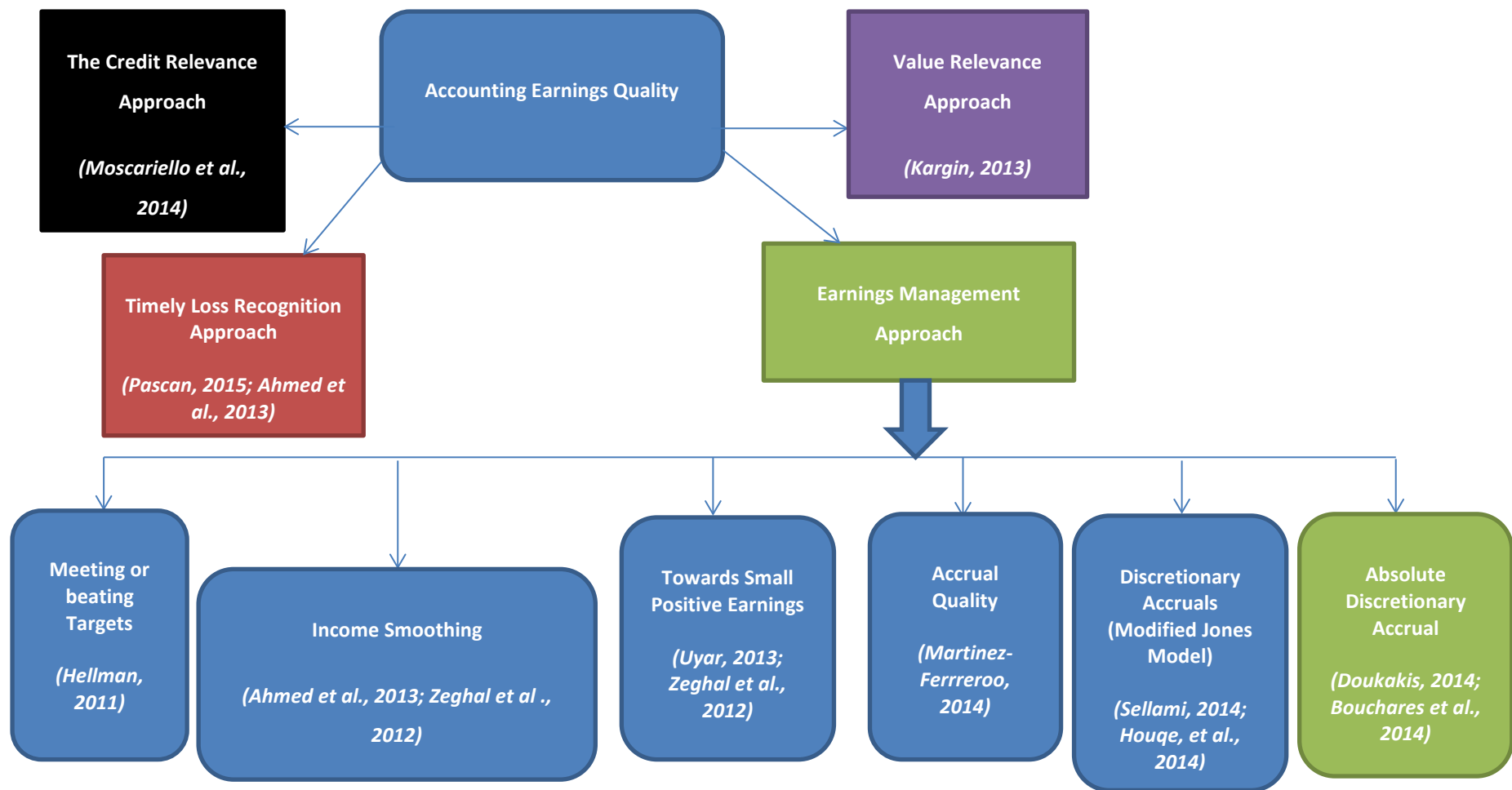


Fig 2.2: Illustration of Diverse measures of Accounting Quality, Earnings Management and Measures.

Source: Author's Compilation

3.3 The Concept of Earnings Management.

Although earnings management is a widely discussed concept, it has been variously termed and described by authors. Marin *et al.* (2002) coined it as apparent extreme earnings manipulation, Dutta and Gigler (2002) call it window dressing and Dechow *et al.* (1996) called it 'within GAAP manipulation'. According to Yaping (2005), there are five categories of which earnings management was conceptually used. These are earnings manipulation (Healy and Wahlen, 1999), paper earnings manipulation (Watts and Zimmerman, 1990), paper earnings fraud (Marin *et al.*, 2002), creative accounting (Levitt, 1998) and paper earnings management (Dechow and Skinner, 2000).

On the argument of whether earnings management is fraudulent or not, Nia *et al.* (2015) espoused the two dimensions to earnings management. In their opinion, earnings management becomes a fraudulent act if used by managers unscrupulously and selfishly to the detriment of shareholders. The primary motive of managers in this dimension is to enhance their compensation. This is consistent with management compensation theory and bonus plan hypothesis (Rahman *et al.*, 2013; Nia *et al.*, 2015). They also argue that earnings management should not be viewed as fraud in as much as the motive is to protect shareholders' interests, and it is done within the confinement of the Generally Accepted Accounting Principles (GAAP). Earnings are often smoothed by managers to have a consistent and predictable earnings stream, which is of great benefit for existing and potential shareholders. As argued by Habib *et al.*, (2011), from the point of view of investors, risks are minimised, and earnings prediction is made simple when current and prior year's earnings are smoothed. This implies that the distinction between earnings management and fraud can always be assessed on two gauges: the motive behind the act and the consequences of the act.

3.3.1 Earnings Management Defined

Financial statements serve as a vital communication tool through which managers communicate the performance and disposition of their companies to users. Shareholders and potential investors often rely on financial information from published accounts of firms to know whether a company is ‘good’ or ‘bad’ for investment. Although the import of managerial discretion is to enhance disclosure, it has been established in the literature as an avenue for earnings manipulation by managers (Tsitinidis and Duru, 2013; Hazarika *et al.*, 2012). This could be aggravated by flexibility in accounting standards, especially where there are several alternatives to the treatment of a transaction. Hence, decisions and actions of managers in the process of preparing the financial statements of the company they serve might be ‘unfair’ to the shareholders.

Earnings management (EM) has been variously defined, and to date, there is no universally accepted definition of the concept (Beneish, 2001, Dechow, *et al.*, 1996 and Messod, 2001). In the words of McKee (2005), earnings management is a reasonable and legal managerial decision making and reporting activity aimed at achieving consistent and predictable financial results. This definition paints a positive picture of EM. However, it is criticised as a rationalisation of the deliberate denial of rights of shareholders to true and fair business results. It also conceals the true performance of the organisation. On the other hand, Schipper (1989: 92) defines it as “*the process of taking deliberate steps within the constraints of the Generally Accepted Accounting Principles (GAAP) to bring about the desired level of reported income*”.

According to Schipper (1989), EM is a “*purposeful intervention in the external financial reporting process with the intent of obtaining some private gain.*” This depicts a negative dimension to earnings management by focusing on private gains without considering their

implications on the quality of the financial statements. In the same vein, Hui and Fatt (2007), define earnings management as an intentional structuring of reporting or production/investment decisions around the bottom line impact. In this vein, Healy and Wahlen (1999) describe EM as what occurs “*when managers use judgments in financial reporting 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*”. However, Nelson *et al.* (2002) perceive EM as illegal, unethical and a biased financial reporting practice.

While the academic debate on the legality of EM continues, the reflection of this on the mixed findings in the literature remains. While some proponents argue that EM is acceptable if exercised within the scope of the GAAP (Barton *et al.*, 2010; Davis-Friday and Frecka, 2002; Peasnell *et al.*, 2000, Watt and Zimmerman, 1990), some authors view EM as a legal managerial effort to ensure achievement of consistency in reported earnings. This school of thought emphasises that EM should not be viewed as a manipulation of financial statements which conceals the economic reality of the reporting firm. Financial misstatement or fraud or ‘cooking of books’ misrepresents the economic reality of firms (Stolowy and Breton, 2004; Guan *et al.*, 2005; Koumanakos *et al.*, 2005). In achieving their financial objectives, firms use both legitimate and illegitimate means. Also, financial decisions of managers have a prospective impact on the earnings. However, the question is: how can the managerial efforts of management to meet their (legal) expectations be distinguished from manipulative or fraudulent (illegal) EM activities?

The National Association of Certified Fraud Examiners (2016) defined financial fraud as “*the intentional, deliberate misstatement or omission of material facts or accounting data, which is misleading and when considered with all the information made available, would cause the*

reader to change or alter his or her judgement". In furtherance to this, Alan (2010) advanced three bases for identifying financial fraud: material and false misstatement with the intent to deceive, proof that the victim placed reliance on the false statement, and that damages ensued on reliance on such false statement. In distinguishing earnings management and fraud, Dechow and Skinner (2000) classified and clarified this as shown in table 2.1 below:

Categories	Accounting Choices	Real cash flow choices
	<i>within GAAP</i>	
"Conservative" Accounting	Excessive and aggressive recognition of provisions and reserves, overvaluation of R and D costs, overstatement of restructuring charges and asset write off	Delaying sales, accelerating R and D or advertising expenditures
"Neutral" Earnings	Earnings resulting from the neutral operation of the business	
"Aggressive" Accounting	Understatement of the provisions for bad debts Drawing down provisions or reserves in an excessively aggressive manner	Deferring R and D or advertising expenditures, accelerating sales
	<i>Outside GAAP</i>	
"Fraudulent" Accounting	Recording sales before realisation, recognising fictitious sales, backdating sales invoices, overstating inventory through fictitious inventory	

Table 2.1 Difference between Earnings Management and Fraud

Source: Adapted from Dechow and Skinner (2000)

The ambiguity in definitions of earnings management might lead to a misconception, mistaking companies practising earnings management for companies practising earnings fraud. This will, therefore, fuel unnecessary conflict as well as inordinate disagreement between firms and their regulatory authorities. Hence, this will incidentally enhance earnings fraud. Every country has its own GAAPs just as its own corporate laws. The variability in definitions of EM might result from these diversities. What is labelled earnings management in one country may be labelled earnings fraud in another country. The cure to this might be the adoption of global standards – IFRSs - that would enhance uniformity, promote the quality of financial reporting and boost investors' confidence.

Adoption of IFRS can be considered to be advantageous to the quality of reported financial statements if the incidence of earnings management is reduced. According to Barth *et al.* (2008), IFRS removes some alternatives for treating accounting transactions leading to less exercise of opportunistic earnings management and ultimately better accounting quality.

The literature documents the different names⁸ and their proponents, as far as measuring the extent of earnings management is concerned.

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- (a) ⁸ Earnings smoothing (Ahmed *et al.*, 2013; Zeghal *et al.*, 2012; Paanamen and Lin, 2009; Christensen *et al.*, 2008; Chen *et al.*, 2010; Hellman, 2011; Uyar, 2013)
 - (b) Earnings management toward meeting or surpassing a target (Ahmed *et al.*, 2013; Chen *et al.*, 2010)
 - (c) EM towards small positive earnings (Zeghal *et al.*, 2012; Christensen *et al.*, 2008; Uyar, 2013)
 - (d) Absolute discretionary accruals (Zeghal *et al.*, 2012; Doukakis, 2014; Bouchareb *et al.*, 2014; Boumediene *et al.*, 2014; Chen *et al.*, 2010; Uyar, 2013); or Absolute value of abnormal accruals (Lopes *et al.*, 2010).
 - (e) Accruals quality (Zeghal *et al.*, 2012; Martinez-Ferrero, 2014; Chen *et al.* 2010)
 - (f) Discretionary accrual (Houqe *et al.*, 2012; Francis and Wang (2008)

Throughout this thesis, following Houque *et al.* (2012) and Francis and Wang (2008), discretionary accrual will be used as a measure of earnings quality. Therefore, any factors found to have a negative correlation with discretionary accruals (as noted in the later results chapter) can be adjudged to have contributed positively to earnings quality.

3.3.2 Measurement of Earnings Management

The literature evidenced three major platforms on which earnings management has been empirically investigated: earnings distribution, return on assets ratio and accruals methods (Yaping, 2005). In measuring earnings management with earnings distribution, Goel and Thakor (2003) opine that smoothness of earnings distribution over accounting periods of an organisation is an indication that the earnings of such organisation have been managed. The flaws with this method are that earnings management may not be the cause of the earnings smoothing of an organisation. Also, earnings manipulation is just a small segment of the causes of earnings smoothing, hence making earnings distribution a noisy variable.

The proponents of measuring earnings management through return on assets, Balsam *et al.* (2002) use net income as a ratio to average total assets in measuring earnings management. Proponents of the accrual method, Healy and Wahlen (1999), emphasise that the existence of unexpected accruals is an indication of earnings management. Unexpected accruals are the residual items on regression of standard accrual proxies and gross fixed assets. In other words, they are the unexplained portion of total accruals. Conversely, Messod (2001) uses provision for bad debt as specific accruals and accruals like loss reserve in specific sectors such as the insurance industry in assessing earnings management.

Shortcomings of this method are, primarily, that the approach can be affected by information asymmetry as the accruals and earnings management are not inevitably of cause and effect association. While discretionary accruals can be influenced by decisions of the management of an organisation, the relationship between unexpected accruals and earnings management is more of an assumption.

Secondarily, the approach is neither inclusive nor exclusive; accruals are just an aspect of variables that can be manipulated. Variables such as unexpected accruals and production costs might also be used in earnings manipulation. Lastly, unexpected accruals are a noisy variable (Yaping, 2005).

In a bid to test for the extent of earnings management on the adoption of the IFRS, this thesis draws upon various approaches used in prior studies (Christensen *et al.*, 2015; Ahmed *et al.*, 2013, Barth *et al.*, 2008). Five measures of earnings management are conventionally used in the literature by earlier researchers. These are variability in net income, variability in cash flow, the ratio of change in net income to change in operational cash flow, small positive income measure and the tendency of reporting large negative earnings (Christensen, *et al.*, 2015; Barth *et al.*, 2006, 2008; Paananen and Lin, 2008). As results of selected firms in emerging economies would later be explained as for their developed economies counterparts, it is better to adopt a standard threshold that would enhance this. This study, therefore, adopts the absolute discretionary accrual measure (as used in Capkun *et al.*, 2016; Ashbaugh, 2001; Pagano *et al.*, 2002; Lang *et al.*, 2003, 2006; Tarca, 2004), However, change in cash flow approach (as used in Barth *et al.*, 2008 and Capkun, 2016) and variability of net income was adopted as a test for robustness.

Some authors such as Francis and Wang (2008) have advocated signed discretionary accruals in preference for absolute discretionary accruals

for two reasons. Firstly, on the assumption that adoption of IFRS was based on upward earnings management rather than understatement of earnings, reported earnings could be increased by managerial discretion using signed discretionary accruals. Secondly, in line with the empirical report of Hribar and Nichols (2007), discretionary accruals measures earnings quality better than absolute discretionary accruals and thus will be adopted in this study. This study, therefore, focuses on discretionary accrual, although absolute discretionary¹ accrual was briefly discussed as a matter of review with the findings of prior authors. This measure was also used in this study to measure the extent of earnings management among countries.

Furthermore, Jones' (1991) cross-sectional model has been criticised as being unsuitable for the calculation of discretionary accruals in a cross-country study, as the number of industry observations per country might be limited (Francis and Wang, 2008; Meuwissen *et al.*, 2004; Wysocki, 2004). However, more recent studies by Sellami and Fakhfakh (2014), Doukakis (2014) and Chen *et al.*, (2010), use absolute discretionary accruals to determine the extent of earnings management. This thesis builds on this to enhance continuity in the flow of knowledge.

3.3.2.1 Discretionary Measure of Earnings Management

Estimation of discretionary accruals has its origin in the study conducted by Jones (1991). Jones' model is an extension of the accrual-based researchers in the 1980s (Ronen and Sadan, 1981; Healy, 1985; DeAngelo, 1986; DeAngelo, 1988; Dechow and Sloan, 1991). Adopting DeAngelo's (1986) model, Jones (1991) expressed total accrual as a change in non-current assets excluding the change in cash minus change in current liabilities, excluding the change of current maturities of long-term debts and change in income tax payable minus depreciation and amortisation (see methodology chapter). He classified total accruals into normal and abnormal (discretionary) accruals on the

premise that there is a tendency to the incorporation of accounting discretion in accruals.

Jones' (1991) model significantly impacted empirical accounting research. Xie (2001), having used Jones' (1991) model, found that ability to predict future earnings is lower in discretionary accruals than in normal accruals. Despite this, Jones' (1991) model is not without its flaws. It only explains approximately 10% of the deviation of the accruals (DeFond, 2010). The correlation between the residuals from the model and total accrual, as well as earnings performance, was found to be positive but negative with cash flow performance.

The implication of this is that, estimating the discretionary accruals using Jones' (1991) model resulted in the correlated omitted variable problem. Dechow *et al.* (1995) formally illustrated this. Having undergone a linear regression test of earnings management, they observed that Jones' (1991) model omitted some essential regressors in his analysis. Thus, this omitted variable problem could lead to Type I and II errors. That is the rejection of the null hypothesis that firms are not involved in earnings management and accepting the null hypothesis that firms do not engage in earnings management. (Dechow *et al.*, 2010; Ronen and Yaari, 2008). Based on the deficiencies of the Jones (1991) model, and on the necessity for a representative proxy that can adequately capture earnings management, several authors in their methodologies have presented their view on how better earnings management can be measured.

Discretionary accruals have been variously measured using different models in the literature. Examples include the cross-sectional model by Jones (1991), modified Jones model, sector model by Teoh *et al.* (1998), the model propounded by Healy (1985), the performance-based model as developed by Kothari, (2005) and the model propounded by DeAngelo (1986). Dechow *et al.* (1995) have of all the models observed

the modified cross-sectional model to be more reliable than all other models because it can detect earnings management through discretionary accruals. Barton and Simko (2002) also affirm the potency of the model to reveal the effect of managers' discretion in prior years. In addition to this, the model is popularly used in current studies to estimate earnings management (Zang, 2012; Ipino and Parbonetti, 2011 and Cohen *et al.*, 2008).

This study intends to adopt accrual-based earnings management, the absolute version of it and also reported results on the standard Jones model and performance match model to enhance the robustness of the study (as used in Doukakis, 2014; Rudra and Bhattacharjee, 2012; Zeghal *et al.*, 2011; Kothari *et al.*, 2005). However, the study focus its analyses on the modified Jones model and the absolute version of it due to its popularity in current literature.

Modified Jones Model was initially known as the standard Jones (1991) model but was later modified by Dechow *et al.* (1995) by including a change in accounts receivable. They perceived the tendency of management to manipulate revenue and how it is recognised. Apart from its popularity, Dechow *et al.* (1995) in their study attest to the strength of the model in detecting earnings management in comparison to the original model. This will provide a platform for comparison of findings of earlier researchers with the findings of this study. It will also enhance continuity in the flow of knowledge.

3.3.2.2 Real Earnings Management

Evidence from the literature has it that earnings management is not done through accounting choices alone. It could also be achieved through operating, financing and investment decisions. The first measure of real earnings management was developed by Roychowdhury (2006). Based on an operational decision perspective, Roychowdhury (2006) defines real earnings management as “*departures from normal operational*

practices, motivated by managers' desire to mislead at least some stakeholders into believing specific financial reporting goals have been met in the ordinary course of operations."

Discretionary cash flow as it was called equally derived its bearing from the Dechow *et al.* (1998) model. Following the same methodological approach as in the accrual models, operating cash flow was expressed as a linear function of sales and change in sales where sales are used as a proxy for real business activity. The model-like accrual models suffer some methodological shortcomings such as establishing coefficients of firm-level based on year and industry and omitted variable bias.

If the credibility of the financial statement is pertinent, more academic contributions on real earnings management are necessary, especially at this period of the advent of IFRS. The majority of authors on earnings management focus on accounting-based earnings management, neglecting the aspect of real earnings management, which is more difficult to detect (Beneish, 2001). Drawing a clear-cut boundary between what may be tagged optimal decision and deliberate manipulation of accounting figures might be difficult (Sellami and Fakhfakh, 2014; Schipper 1989). In the study conducted by Ewert and Wagenhofer (2005), it was discovered that a stricter accounting standard might reduce accounting earnings management. However, though accounting earnings management may decrease under tighter accounting standards, it may be overshadowed by the impact of real earnings management. This, by implication, would negatively affect the value of the firm and could be costly. In support of Ewert and Wagenhofer (2005), Zang (2007) modelled the trend pattern of real and accounting earnings management and concluded that the duo is better viewed as substitutes than complements.

Various researchers have made their submissions on instruments used by managers in achieving real earnings management. For instance,

Baber *et al.* (1991), Dechow and Sloan (1991), Holthausen *et al.* (1995), Bushee (1998), Bens *et al.* (2003), Cheng (2004), Graham *et al.* (2005) and Gunny (2010) discussed the tendency of deferring research and development costs and other discretionary expenses such as maintenance and advertising to increase income. Also, studies on disposal of valuable fixed assets and timing of recognition of income from such disposal were conducted by Bartov (1993), Hermann, Inoue and Thomas (2003) and Gunny (2010). Hunt *et al.* (1996) researched how the cost of goods sold can be reduced through alteration of shipment schedules, overproduction and inventory management (Thomas and Zhang, 2002; Gunny, 2010). Furthermore, using price-cut and other techniques in boosting sales was identified by Jackson and Wilcox (2000) and Roychowdury (2006), stock repurchases by Hribar *et al.* (2006) and debt-equity swap and derivative hedging by Hand (1989), Barton (2001) and Pincus and Rajgopal (2002).

While establishing a compromise between maximising firm's long-term value and attaining earnings target, managers adopt real earnings management in their cash flow decisions. Graham *et al.* (2005) first espoused the essence of real cash flow decisions as a tool for earnings management. In a survey conducted, almost 80% of US Chief Finance Officers (CFOs) expressed that they would reduce research and development, advertising and maintenance expenses whereas 55% would rather have new projects deferred to meet their targeted earnings. The inference from this survey shows that most of the CFOs emphasised the importance of earnings smoothing because missed earnings target could make the market be in command of the risk premium. Because of this, sacrificing a little proportion of the firm's value could be necessary for attaining smooth earnings or earnings targets, as surprises from negative earnings could be disastrous (Graham *et al.* 2005).

In support of this, Gunny (2010) studies the relevance of real earnings management in target beating and establishes that a positive correlation exists between real earnings management and earnings benchmarks. She also examines the consequences of real earnings management on the future performance of firms. She discovers a negative relationship between attaining earnings targets through real earnings manipulation and stock market performance. However, by analysing returns on the asset in the year after the attainment of earnings targets by the firm, it makes the result of short-term relevance having focused on short-term performance. It would have been better where the result applies to the relationship between firms' value and long-term performance.

Capturing real earnings management could be a challenging task because carving a clear-cut boundary between real earnings management and regular business activities is difficult (Schipper 1989). This could be the reason why real earnings management is less researched in accounting literature in comparison to accounting earnings management (DeFond, 2010: 406). However, Roychowdhury (2006) advances the first empirical attempt to study how operating activities could be manipulated to attain real earnings management. This research focuses on discretionary accruals due to a direct relationship with accounting standards, especially when adoption of IFRS is becoming popular. Real earnings management is more of managers' decision on operational activities of the organisation to influence its reported earnings than on accounting standards. Hence, it is reported in this section for review only.

3.4 Earnings Management: Motives for Managers

Prior studies depicted diverse motivations behind managers' involvement in earnings management. These motives include income smoothing motivations, dodging violation of debt covenant, meeting or beating analysts' expectations, management compensation contract

incentive, regulatory incentives and avoidance of financial distress incentive. These are discussed below.

Income smoothing motivation

Income smoothing is an accounting method that entails that net operating income from one period to another is relatively consistent. As defined by Beidleman (1973), income smoothing is an “*intentional dampening of fluctuation about some level of earnings that is currently considered to be normal for a firm.*” In the same vein, Fudenberg and Tirole (1995) defined income smoothing as the “*process of manipulating the time profile of earnings reports to make the reported income stream less variable, while not increasing reported earnings over the long run*”. Rationally, the stocks of firms having stable and conceivable earnings streams are more attractive to investors than those with wide and unexpected fluctuations.

The literature established various rationales for earnings smoothing. Top of the list is managers’ fear of dismissal for non-performance to the expected standard. Therefore, managers often exercise discretionary accounting choices to have reported earnings close to estimated targets. Primarily, when future performance is expected to be poor, current buoyant earnings are shifted to the future to compensate for any shortfall in the expected earnings and vice versa (Fudenberg and Tirole, 1995). In addition to this, managers may also resort to earnings smoothing to minimise earnings volatility of the firm and to present some justifiable earnings that can influence increased stock prices (Francis *et al.*, 2004; Thomas and Zhang, 2002).

Debt covenant induced motivation.

As crucial as finance is to every business, keeping abreast of every debt contract/covenant is more critical. The lender to borrower relationship is always present in any geared company. The extent of the liability is often measured in ratios such as debt to equity ratio, debt to tangible assets ratio and interest coverage ratio. A bank-related covenant usually demands ratios higher than one to one.

Based on positive accounting theory, companies on the verge of violating their debt covenant usually adopt income increasing approaches to reduce the extent of debt restrictions (Watts and Zimmerman, 1990). Not meeting the covenant demand reveals liquidity and earnings problems of the firm. This, in turn, heightens the default risk that the lender or financier may face (DeFond and Jambalvo, 1994). Also, consistent with signalling theory, violation of debt covenants sends a negative signal about viability, corporate performance and managers' reputation (Nia *et al.*, 2015; Holthausen *et al.*, 1995). In avoidance of the adverse consequences of debt violation, managers may be induced to manage their accounting figures. Contrarily, the studies of DeAngelo *et al.* (1994) and Healy and Palepu (1990) could not find a significant association between firms' violation of debt covenants and earnings management.

Meeting analysts' expectations incentive

During earnings announcement, investors are attracted to the stocks of companies whose earnings meet or beat market expectations. In other words, beating analysts' expectations of a firm's earnings is a great feat for the company. Hence, falling short of market expectations may lead to a considerable reduction in the stock price or loss of executives' bonus or their jobs (Koh *et al.*, 2008). Knowing this, managers might incorporate this into establishing their reported earnings.

Companies whose activities are monitored by analysts or prone to investors' expectations may resort to earnings management while

estimating their reported earnings (Iatridis and Kadorinis, 2009; Lin, 2006). In his speech (1998, September 28), the former chairman of the SEC, Levitt emphasised that the problem of earnings management is a general issue. The market reaction can be so devastating to companies that miss their expectations. As stated by him:

“.....I recently read of one major U.S. Company that failed to meet its so-called number by one penny, and lost more than 6% of its stock value in one day...”

Therefore, for companies to maintain or outperform their market position and financial standing, it would be necessary for them to meet or exceed analysts' forecasts. This might induce managers to earnings management.

Management compensation-contract motives

This happens when the performance of managers is remunerated on the increased value of accounting earnings. The findings of Healy (1999) revealed a high and positive correlation between managers whose remunerations are based on increased earnings figure and the tendency for earnings management. The literature evidenced this in two theories: opportunist theory and management compensation theory (also known as bonus plan hypothesis). The opportunistic theory advocates the tendency of managers to act motivated by selfish incentives by using loopholes allowed by the flexibility of accounting standards while managing earnings (Degeorge *et al.*, 2013).

On the other hand, the bonus plan hypothesis emphasises that managers' engage in earnings management because their bonuses are dependent on their reported earnings (Rahman *et al.*, 2013). Managers might adopt income-declining accounting techniques on observing that earnings fall below the lower threshold or rise above the upper level estimated by the bonus plan. In support of these theories, Chan *et al.*

(2012) opine that managers are interested in ensuring stable earnings growth over the years due to the ultimate impact on stock prices. Further, they will be remunerated on this basis. These findings revealed that earnings might not adequately mirror the consequences of managers' decisions in the long run.

Regulatory incentives

The action of regulatory agencies might induce managers into earnings management, just as earnings management can trigger the action of regulatory bodies. Based on the argument of Jackson *et al.* (2016), the practice of earnings management may provoke the actions of regulatory agencies, including the government. This reduces political inspection and regulatory effects. For instance, regulations and compliance controls for the finance and utilities sectors are usually assessed based on accounting ratios and figures. This is to ensure that their capital and assets keep them liquid enough to meet their financial commitments (Rahman *et al.*, 2013). While trying to meet these requirements, managers often engage in earnings management.

Financial distress avoidance motive

Another reason why firms manage their reported accounting earnings is to circumvent or defer financial distress. Wruck (1990) defined financial distress as a condition where firms find meeting their financial obligations to their creditors difficult. The concept is typically related to the firm's obligations to indirect costs like expensive financing or opportunity cost of projects and, in the long run, bankruptcy. Therefore, managers may purposely conceal the real financial status of the firm by 'dressing' the published financial statement in such a way that it would not present the companies as being financially distressed (Garcia *et al.*, 2009).

Fear of bankruptcy affects the morale of reporting managers. They are usually motivated to engage in earnings management so that the reported earnings meet targets and by doing so, they postpone bankruptcy (Rosner, 2003; Nia *et al.*, 2015). The findings of Saleh *et al.*, (2005) reveal that manipulation of earnings is predominant among managers of distressed firms to overcome a temporary period of difficulty. Consistent with this, having studied 293 failed companies in the US; Rosner (2003) discovered that earnings are manipulated in an upward manner through accruals during on-going concern years that preceded their bankruptcy. In support of this, Caban-Garcia (2009) stated that executives whose companies are financially distressed engage in upward earnings management through manipulating accounting accruals and real accounting earnings management.

3.5 Peculiarities of IFRS

Adoption of IFRS has been considered as an excellent step in the right direction for adopting countries due to some of its attributes. All adopting countries are therefore open to the potential benefits of the standard regarding popularity, high-quality and high reliability (Ball 2006). One of the features of the standards is that foreign investors could now have high-quality financial statements suitable for informing investment decisions. The comprehensiveness of the standards regarding reporting disclosure gives it more credence than most local GAAPs. This is a necessary pre-requisite for effective capital market dealings. Hence, authors in this field described IFRS as a capital market inclined standard with more relevance to investors (Daske and Gebhardt, 2006).

Secondly, it has been empirically established that the higher level of disclosure promoted by the IFRS correlates positively with the quality of published financial reports prepared on its basis (Ball, 2006; Wan-Ismael *et al.*, 2013). Supported by Carlin *et al.* (2007), the IFRS

framework demands a superior level of disclosure than local GAAPs. This has necessitated accounting treatments such as the valuation of goodwill and disclosure regarding classification of assets to assume different techniques. Also, Levitt (1998) argued that the strength of the capital market is highly dependent on the quality of the financial reporting system. The comprehensive disclosure that IFRS offers boosts investors' confidence in the reliability of published financial statements.

Thirdly, fair value accounting is another vital attribute of IFRS. Reporting firms' business activities based on fair value will result in more reliable, timely and relevant financial reporting (Wan-Ismail *et al.* 2013). Accounts prepared with these features are bound to provide better information quality to users. The significant benefit of fair value accounting is that assets and liabilities of companies are valued continuously to reflect their real economic worth. Financial information gained from this enhances the accuracy of decision-making of investors. Conversely, fair value accounting has been criticised on the basis that there need to be efficient asset pricing markets in place for assets to be valued at their fair value.

Given the recent popularity of IFRS adoption among countries, are there asset pricing markets that are viable enough to provide essential information about the basis on which assets can be revalued objectively and credibly? The implication of this is that firms may resort to using copied models or evaluations based on the prices of comparable assets. However, such estimates might be unique to the country where it was applied (Hoogendoorn, 2006; Ball, 2006).

Lastly, another argument that distinguishes IFRS is that it reduces earnings management more than local GAAPs. Hence, IFRS-based financial reports are often seen as financial reports of higher quality. As argued by Ewert and Wagenhofer (2005), good accounting standards

have the potential to curb the level of earnings management and enhance the quality of reported business activities. Further, earnings management can easily be spotted when financial statements of companies from different countries are prepared using uniform accounting standards. Also, where firms are constrained to the alternative treatment of accounting transactions, there would be an enhancement of firms' reporting motives. This research focuses on this aspect by evaluating how IFRS has impacted on the quality of published financial statements after a decade and whether the efficacy of IFRS is dependent on the socio-economic factors of adopting countries or not.

3.5.1 Benefits of IFRS Adoption

The literature documents the beneficial aspects of IFRS adoption. Chua and Taylor (2008) found increased transparency, quality and comparability of financial statements prepared based on IFRS. Having studied Spanish listed firms, Callao *et al.* (2007) compare Spanish GAAP with IFRS. They discovered that accounting numbers and financial ratios varied significantly under the two standards. They argued in favour of IFRS adoption that comparability is enhanced under IFRS. On the contrary, Tendeloo and Vanstraelen (2005) could not trace the reduction of EM among German listed firms to the adoption of IFRS. They argued that no difference exists in the EM phenomenon using German GAAP or on the adoption of IFRS. They emphasised the importance of high-quality standards (IFRS) for the protection of investors' interests. In their analyses of 15 countries, all of which are EU members, Chen *et al.* (2010) found that most accounting quality measures show improvement following the adoption of IFRS. Also, they emphasised that subscribing to IFRS adoption attracts improved accrual quality through a reduced absolute value of DA and reduced EM behaviour.

The rate at which countries are now adopting the IFRS is a wakeup call to the realisation of the benefits accruable from it. One of the arguments

for this is the tendency of uniform accounting standards to enhance reduced information asymmetry that has previously been a barrier to the mobility of capital between countries. Among factors that affect the cross-border flow of capital among countries are the risks of the exchange rate, information asymmetry, the distance between countries and capital control. The research conducted by Gordon and Bovenberg (1996) prioritises information asymmetry.

Rationally, foreign investors would like to avoid paying more for investment information than their domestic counterparts and having a good grip on the economic information about their countries. Apart from this, domestic investors can reasonably predict the economic bearing of their countries as well as the implications of government policies. Understanding the rules and regulations of a country might be difficult for foreign investors, thereby leading to inefficient investment deals and delays in investment decisions (Dikova *et al.*, 2010). This problem is worsened where significant differences occur between the local GAAP and the IFRS, thus causing foreign investors to be information disadvantaged. Therefore, the argument to have a uniform accounting standard will not only reduce information asymmetry but will also iron out institutional differences and transaction costs. This will ultimately enhance the mobility of capital between countries (Chen *et al.*, 2014).

In the literature, there exists both empirical and theoretical evidence on the tendency of information asymmetry to improve cross-border investments between countries. In the research conducted by Yip and Young (2012) on nine European countries that adopted IFRS in 2005, they observed that information comparability measures used proved to be significantly higher in the post-IFRS period than the pre-IFRS period. The study conducted by Horton *et al.* (2010) also confirms this.

The choice of accounting standards used and effective corporate disclosure norms have an essential effect on the quality and quantity of accounting information at the disposal of investors and will lead to their having reduced cost of capital (Chen *et al.*, 2014). Recent research reveals that countries that have adopted IFRS have better access to global capital. This will enable them to embark on feasible projects and make their shares tradable in international financial markets. Also, raising funds in international markets becomes easier for such companies (Covrig *et al.*, 2007).

According to Bruggemann *et al.* (2009), adoption of IFRS has also led to a rise in the trading activities of investors. Chan *et al.* (2013) and Yu (2009) also argued that a significant correlation between adoption of IFRS and lower cost of equity encourages investments. Aligning with this, Covrig *et al.* (2007) discover that voluntary IFRS adoption among countries with poor information systems has led to an increased volume of foreign mutual fund investments among them. Based on this fact, local fund managers prefer investing in firms that have adopted IFRS rather than non-adopting firms.

Provision of comparable and useful accounting information as afforded by IFRS is the motivational factor for cross-border investment transactions: as information cost is reduced, foreign investors will have a comparable platform for investing their funds. In line with these, countries with poor investment protection and higher financial risk will find adoption of IFRS having a positive impact on cross-border debts (Beneish *et al.*, 2010).

Just like any innovation, the expectation of academics, analysts, accounting firms and standard setters to mention just a few, were very high for the previous decade. The same is open to evaluation, and academic debate and one could wonder if the expectations have been achieved. According to Ball (2016), the expectations remain the vital

yardstick in evaluating the benefits of any system innovation and not the known facts. As discussed in Ball (2016), the expectations related to asset markets, cost of capital to the public corporations, corporate governance and markets. These are considered below:

Asset Markets: When statements are prepared based on quality standards, higher quality of financial information and increased transparency ensues. Thus, information risk to lenders and shareholders is minimised. This can be achieved directly through detailed disclosure of information in the financial statements or by enhancing the reliability of financial information supplied through other sources. Adopting a uniform accounting system provides a uniform basis for comparing financial results of firms from different countries. It can also provoke cost reduction regarding analysts' research and the cost of creating standardised international financial databases (Ball, 2016). The relevance of this lies in better public information resulting in a more accurate valuation of equity and debt markets.

Corporate Governance: Adoption of IFRS is expected to enhance corporate governance. When managers have at their disposal accurate and timely information, their decisions are bound to be good. Transparent reporting of managers' actions and the implications of this exposes them to investors', boards', analysts' and other users of financial statements' scrutiny. Based on this, managers would be eager to change bad decisions on time as they may face severe penalties for not doing so.

Cost of Capital: Disclosure of vital and reliable information financial information gives investors the necessary data for informed investment decisions, thereby minimising risk. The lower the risk, the lower the return the investor will require. The resultant effect of this is a reduction in the cost of capital. Also, capital creation will be enhanced, and shareholders' wealth maximised.

Market generally: Another expectation envisaged in IFRS adoption is reduced cross-border transactions to investors, lenders, customers, labours and suppliers. Through this, the number of market participants, especially public corporations, increase without border limitation. This will undoubtedly result in the efficiency of the market.

3.5.2 IFRS Adoption and Quality of Financial Reporting.

The International Financial Reporting Standards originated as one of the initiatives of the Financial Services Action Plan (FSAP). It was inaugurated in the late 1990s. The intention was to boost capital market operations through increased financial disclosure, its enforcement and enhanced administration. In 2005, all EU listed companies were mandated to prepare their consolidated financial statements in line with IFRS (Doukakis, 2014; Kalemli-Ozcan *et al.*, 2010; Byard *et al.*, 2011b).

Although IFRS gained prominence in 2005, it has been in existence under a different name - IAS, since 1973. Presently, over 100 countries have subscribed to the IFRS. It is anticipated that IFRS adoption should enhance the quality of financial reporting and facilitate an improved presentation of firms' performance. However, these presumed benefits have been debated among academic scholars. Hence, arguments about whether financial information under IFRS regime is more reliable than before remain vibrant in accounting research.

One of the benefits of IFRS adoption is to have uniform and international accounting standards that enhance fairness in the financial statements prepared by an organisation. As claimed by the IASB, the primary objective of IFRS is to “*develop in public interest, a single set of high-quality, understandable and enforceable global accounting standards that require high-quality, transparent and comparable information in financial statements*” (IFRS, 2013). Scholars have debated this objective in a quest for whether the quality of financial

reporting is dependent on the adoption of IFRS. Some compare the old GAAP with IFRS value relevance while others specifically divide their period of analysis into the pre-IFRS adoption era and post-IFRS adoption era and test which era best encourages qualitative accounting information (see Suadiye, 2012; Turel, 2009; Christensen *et al.*, 2007; Horton and Serafeim, 2006; Bartov *et al.*, 2005). Inconsistent findings were observed because the studies were conducted in different countries, with each having peculiar national and institutional characteristics.

The IFRS is perceived by regulators to boost corporate transparency and comparability of financial statements and enhance the quality of financial reporting. In other words, financial reporting quality increases where adoption of IFRS restricts management's discretion to manage earnings. Therefore, if IFRS is superior to local GAAP, there would be a decrease in earnings management practices. However, contrary to local GAAP, the flexibility of IFRS as a principle-based standard may eventually encourage earnings management. Hence, there is a need for further research on this aspect.

There also exists an argument about whether changing accounting standards could make financial reports comparable among companies or improve their reporting behaviour. The literature reveals that the reporting policies of firms that oppose the transition to IFRS are unlikely to be materially changed (Daske *et al.*, 2007; Ball, 2006). Also, it is uncertain that firms will disclose figures that are informative through more disclosure of estimates, even if IFRS advocates better accounting practices. Ball *et al.* (2003) studied firms from four East Asian countries whose accounting standard is of high quality (derived from US, UK GAAP and IFRS). He observed that the influence of the inducements in issuing financial reports faced by managers and auditors overrides that of the accounting standards. The findings of Leuz and Oberholzer-Gee (2006) also disclose that adopting universal standards

does not guarantee consistent reporting behaviour among firms, as the reporting incentives of each of the firm will differ.

Adoption of IFRS might be an essential factor in the production of qualitative financial reports, but it is not an ‘all in all’ factor. Countries have their different economic, political, social and cultural factors (Ball *et al.*, 2003). This accounted for the difference in the accounting system as practised by different countries (Ali and Hwang, 2000; Ding *et al.*, 2007; and Jeanjean and Stolowy, 2008).

3.5.3 IFRS adoption and Accruals-Based Earnings Management

The effect of the adoption of IFRS on deterring earnings management has been widely empirically researched. However, what distinguishes this research from prior studies is the question of how the uniform standard can uniformly reduce earnings management with countries at different levels of economic development. No work, to the best of my knowledge, has empirically tested how the efficacy of IFRS in curbing earnings management can be sensitive to the level of economic, political and human development of adopting countries.

Reviewing prior studies, two principal schools of thought exist on the interaction of the adoption of IFRS on EM. A school of thought argues that the adoption of IFRS has a connection with reduced accounting earnings management. Houqe *et al.* (2012) having studied 46 countries around the world, found that earnings quality improved on the adoption of the international financial reporting standards especially with countries having strong investors’ protection mechanisms. They also emphasised the tendency of accounting practices to being influenced by country-specific variables portrayed by their background. Having studied some German firms from 1998 to 2008, Guenther *et al.* (2009) found a reduction in the use of discretionary accruals. The reduction was ascribed to the adoption of IFRS by German firms. Also, Barth *et*

al. (2008) opined that financial reporting quality could be enhanced if standard setters by their regulatory actions prevent opportunistic earnings management by curbing managers in determining accounting figures.

Furthermore, Chen *et al.* (2010) evaluated 15 European Union countries from 2000 to 2007. They discovered that the adoption of IFRS is a pointer to a reduced level of absolute discretionary accruals. They argued that the lower motivation of managers managing earnings towards a target and higher accounting quality are traceable to the adoption of IFRS. The findings of the study of Zeghal *et al.* (2011) on 353 French listed companies for the period between 2003 to 2006 and Zeghal *et al.* (2012) on 1547 EU firms between 2001 and 2008 align with those of Guenther *et al.* (2009) and Chen *et al.* (2010), i.e. that adoption of IFRS enhances earnings quality. In the US context, Sun *et al.* (2011) for a study period of 2003-2005 and Liu *et al.* in the Chinese context for the period of 2006-2008 established the same finding.

The second school of thought argues that the adoption of IFRS does not improve the earnings quality of reporting firms. Jeanjean and Stolowy (2008), having examined listed companies in France, UK and Australia, observed that EM did not reduce on the adoption of IFRS with emphasis on France having increased EM on the adoption of IFRS. The implication of this is that managers managed their earnings to avoid reporting losses more after the mandatory adoption of IFRS than before the mandatory adoption period.

The empirical result of a study on 11 European countries by Callao and Jarne (2010) shows that earnings management magnified the implementation of IFRS and that discretionary accruals increased on the adoption of the IFRS. Using data in New Zealand from 2002 to 2009, Kabir *et al.* (2010) discovered increased absolute discretionary accruals after the adoption of IFRS. This implies that earnings quality

after the adoption of IFRS is lower in comparison to when New Zealand GAAP was in force.

In the same vein, the study of Elbannan (2011) on Egyptian listed firms between 1997 and 2006 posited that the reduction of earnings management after IFRS adoption was statistically insignificant. The cause of this was attributed to non-compliance on the part of the reporting firms, weak regulatory and enforcement mechanisms, substandard accounting systems and poor skills on the part of accounting practitioners. In line with this, Rudra (2012) argued that Indian firms that adopted IFRS found it difficult to resist earnings management; neither were they able to improve their earning quality. He questioned the integrity and effectiveness of the IFRS in countries having poor capital market paradigms and institutional infrastructures that can support its implementation.

Given that the empirical findings from prior researchers on the effects of mandatory adoption of IFRS, the evidence on accounting earnings management is mixed. Their studies were mostly on a limited number of years close to the transitional period, the year 2005. The result from such a short period of analysis might be unlikely to adequately reflect the phenomenon of the concepts of study - IFRS and EM. In a contribution to the academic debate, this research used a more extended period of study (10 years pre-adoption and 10 years post-adoption) using selected firms.

3.6 Factors influencing the Adoption of IFRS/IAS.

The financial reporting quality prepared has been observed to be dependent on the quality of standards (IFRS/IAS) from which they are prepared and the enforcement of their implementation (Van-Tendeloo and Vanstraelen, 2005). However, the institutional factors creating an enabling environment for the application of the standards have long been neglected as most researchers in this area either considered the

factors that are influencing the adoption of IFRS separately or the relevance of the standards in promoting quality financial statement. This research, therefore, contributes to the literature by discussing the factors enhancing the free flow adoption of IFRS as it affects the reliability of financial statements. These factors are classified into international market inclined factors and corporate governance induced factors (Zeghal *et al.*, 2011; Van Tendeloo and Vanstraelen, 2005).

Listing on Foreign markets

Earnings quality, according to research findings, is boosted when a firm is listed in capital markets of international status (Ball *et al.*, 2003). Reports prepared by such firms tend to be more transparent as they endeavour to satisfy the restrictions from different countries and at the same time, avoid litigation risks. The studies of Ball *et al.* (2003) and Street and Gray (2002) also revealed that listed firms in foreign financial markets exhibit high compliance to IFRS and thus have the quality of their financial statements enhanced. Zehri and Abdelbaki (2013) also highlight the relevance of capital market operations as an influencing factor for IFRS adoption. In their opinion, the quality of financial information is a critical factor for a sound and efficient capital market.

However, the primary issue against IFRS adoption is how the operation of the capital markets of all countries could be facilitated to protect investors' interest. Gray *et al.* (1995) suggest that investors, while analysing investment opportunities and getting the best from a choice made, need up-to-date information. Following the results of Jemakowicz and Gornik (2006), countries having their capital markets opened to international investors have a high probability of adopting IFRS due to the uniformity and comparability it emphasises. This research will, in this light, examine the influence of the adoption of IFRS on earnings management of internationally listed companies from

both emerging economies and developed economies. It will also explore the impact of this on the volume of equity traded in the market through the variable EISSUE (see methodology chapter).

3.7 Economic Implications of Earnings Management

The case of Enron and WorldCom challenged the credibility of published financial statements. This caused a shift in public perception negatively regarding the objectivity of financial reporting. Hence, the indulgence of managers in earnings management is usually perceived to be for their interest and not usually in the interest of the shareholders (Zang *et al.*, 2016; Liu and Sun, 2015; Jiraporn *et al.*, 2008). This is usually the case where managers' compensation is based on option holdings or stock values of their companies. The findings of Bergstresser and Philippon (2006) revealed that such managers exhibit a high inclination towards earnings management. In addition to this, avoidance of reduced earnings/losses and keeping to the terms of debt contracts are also signals of earnings management (Iatridis and Kadorinis, 2009; Park and Park, 2004; Dechow and Skinner, 2000).

The incentives of managers to earnings management, notwithstanding, financial statements that do not reflect the economic realities of the reporting firms are disadvantageous to both existing and potential investors. When reported earnings are manipulated, it results in inefficient investment decisions and direct costs on the part of investors (McNichols and Stubben, 2008). Manipulated earnings also put a question mark on the integrity of reported figures and ultimately damage the reputation of the reporting firms. According to some scholars, earnings management is financial fraud and unethical practice, with adverse consequences for the image of the firms concerned (Perols and Lougee, 2011; Chia *et al.*, 2007; Beneish, 2001).

Conversely, other scholars' do not perceive earnings management as fraudulent or unethical acts. In their opinion, it is an effective practice

to improve the value of information made available to users of financial statements (Subramanyam, 1996; Arya *et al.*, 2003; Watts and Zimmerman, 1990). In support of this, Jiraporn *et al.* (2008) argued that engaging in earnings management is not in the interests of the management and that there is no evidence of its being disadvantageous to the firm. They emphasised that managers engage in earnings management as a means of meeting analysts' earnings expectations of their firms and reducing finance costs and the tax burden. They disagree with the notion that managers manage earnings to obtain robust compensation.

Furthermore, real earnings management, rather than accounting accrual management, enhance shareholders' wealth and not that of managers (Barton *et al.*, 2010). The findings of Hamm *et al.* (2015) revealed that stock prices are enhanced when earnings management is done in a less transparent disclosure regime without causing any harm to the status of the reporting entity. However, earnings management under a transparent disclosure administration will impact negatively on the stock price and the firms' integrity. EC Regulation no. 1606 (2002) highlights the advantages of adopting international standards within the community. This includes ensuring a high level of transparency and comparability in financial reporting and ensuring efficient operation of global capital markets and local markets (EC, 2002, article 1).

According to the literature, some researchers studied the influence of IFRS adoption on accounting figures (Neag, 2014; Hung and Subramanyam, 2007; Jaruga *et al.*, 2007; Jermakowicz, 2004). Some evaluated the benefits emanating from switching to IFRS (Armstrong *et al.*, 2010; Schleicher *et al.*, 2010). While some explore the constraints that might impede IFRS implementation (Street and Larson, 2004), others evaluated the effect of IFRS adoption on taxation (Păunescu, 2015). This study evaluates the efficacy of IFRS in promoting the

quality of reporting accounting figures and the sensitivity of this to the economic environment of the reporting firms.

However, various research design models have been used by authors in evaluating the effect of adopting IFRS on information quality of financial reports. These include the value relevance model (Filip and Raffournier, 2010), the earnings management model (Barth *et al.*, 2008; Brad *et al.*, 2014; Nichita, 2014) and the accounting conservatism model (Andre *et al.*, 2013; Maşca, 2014). As noted by Pascan and Neag (2013), assessing the impact of IFRS adoption on financial reporting quality sounds good but is not enough. Likewise, appreciating the contribution of IFRS to financial reporting quality should be viewed as a means to an end and not an end in itself.

There is a need for further investigation of the economic implications of perceived increased information quality on IFRS adoption among countries (Pascan, 2015). Hence this research explores the economic implications of IFRS adoption for the users of financial statements. This study acknowledges the essence of financial reporting quality after IFRS adoption. However, it emphasises that the projected paybacks of the process of convergence and implementation of IFRS are dependent not only on the state of the adopting firms but even more so on the political and economic features of the country in which they are domiciled. This is one of the contributions of this research to the existing bodies of knowledge.

Based on the argument of Pascan and Neag (2013), the IFRS stand the chance of improving financial reporting quality of published financial statements, regardless of country-specific or institutional factors. This section of the thesis discusses the feature of IFRS that has the potential of improving financial reporting quality and the justification of expecting an increased accounting quality on the adoption of the standard.

3.7.1 IFRSs as principle-based standards

The principle-based standard (IFRS) was an initiative of the IFRS Foundation to devise uniform high-quality, logical, enforceable and globally accepted financial reporting standards that could address core issues in accounting. The reason behind IFRS being called principle-based standards lies in the fact that they only provide direction as far as the recognition, measurement and presentation of financial statements items are concerned.

The case of Enron and WorldCom demonstrates how rules can be manipulated to hide crucial financial facts that ought to be disclosed. Accountants will always need the principles as itemised in IFRS in making their professional judgements. The principle inclined nature of IFRS makes its manipulation difficult, thereby promoting financial statement credibility. In addition to this, it affords accountants the opportunity of exercising professional judgment to ensure financial reports portray the economic reality they are supposed to measure rather than striving to comply with the necessary rules.

The fair value accounting promoted by IFRS enhances the disclosure of the economic reality of the reporting companies, unlike local GAAPS. Financial statements prepared based on fair value statements enhance the quality of such accounts and gives a better basis for informed decisions by investors or other users.

Since 2001, the IASB has been striving to discourage alternative treatments to business transactions, so that financial statements would reflect more objectively the financial position and performance of the reporting entity. This is to ensure that financial reporting based on IFRS reduces possibilities to earnings management practices, thereby encouraging improved quality of financial accounting data. As reported by Ewert and Wagenhofer (2005) and Barth *et al.* (2008), published financial statements can be adjudged to be of good quality if reported

based on accounting standards that resist opportunistic earnings management. This will ensure that reported accounting earnings better reflect the economic reality of the reporting firm.

3.8 Prior Studies and Gap on Economic Implications of IFRS adoption.

The quality of reported financial data and financial reporting system can be further enhanced if the adoption of IFRS enjoys stricter enforcement (Barth *et al.*, 2008, p. 468). Nevertheless, given the mixed results of the effects of IFRS on the quality of accounting data in the literature, a general conclusion cannot be made that adoption of IFRS guarantees transparency, comparability and reliability of financial reports. In addition to this, even if reported financial statements improved in quality based on transparency and comparability because of IFRS adoption, the economic implications of such improvement cannot be predicted nor could its achievements be guaranteed. Therefore, this thesis appreciates the fact that the economic effects of the convergence process of international accounting standards can be well understood only if known economic consequences resulting from the adoption of IFRS are evaluated based on the diversities of users of financial statements.

Brüggemann *et al.* (2013) defined the economic consequences of financial reporting as “*effects of financial reporting on firm values and on the wealth of those who make or are affected by decisions based on accounting information*”. They also relate it to “*the impact of accounting reports on the decision-making behaviour of firms and their stakeholders*”. Hence, in line with this, it is pertinent to investigate the economic consequences of higher accounting data quality following the adoption of IFRS. Brüggemann *et al.* (2013) have categorised economic implications of IFRS adoption into those resulting from the mandatory adoption of IFRS according to the objectives of the EU

Regulation 2002 and the application of international accounting standards. This includes:

a) Financial reporting impact accruable from compliance with IFRS requirements and its accounting choices. If the insight into economic consequences of IFRS adoption as regards comparability of financial statements among countries is to be appreciated, it is necessary that these effects be tested. In this category are accounting features, for instance, earnings quality measured in the literature as earnings smoothing, conditional conservatism and discretionary accruals. Exploring these features signals whether mandatory adoption of IFRS has promoted transparency in financial reporting or not.

Further to this is the value relevance study. This relates to the capacity of information presented in the financial statements prepared based on the IFRS to reflect the value of the reporting entity.

b) Capital market effects, which include enhancing stock market liquidity, reducing the bid-ask spread, lowering the cost of equity capital, increasing the propensity to invest in equity by institutional investors, reducing the cost of public debt, increasing the firm-level efficiency of capital investment, increasing the information content of earnings announcements and improving the quality of analysts' information environment.

c) Macroeconomic effects, such as an increase in foreign direct investment.

According to Ahmed *et al.* (2013) in their documentation of the beneficial economic implications emanating from mandatory IFRS adoption in respect of the enhancements of the accuracy of analysts' forecasts, show that decrease in the cost of equity capital and the favourable reaction of price to events undergo a rise following IFRS

adoption. However, these findings have been contested with the result of empirical research on 20 countries that adopted IFRS in 2005.

Using selected firms that did not adopt IFRS in the countries as a benchmark, Ahmed *et al.* (2013) argue that improvement in the quality of accounting figures may not be an explanation for these favourable economic consequences. Also, Martinez-Ferrero (2014), while testing for the relevance of improved quality of accounting information resulting from the adoption of IFRS on corporate performance, found that the quality of accounting information increased thus enhancing transparency and reducing informational asymmetry. This meets the information needs of investors and other users of financial statements. Amiram (2012) also argues that countries that adopt IFRS enjoy higher foreign equity portfolio investments. Moscariello *et al.* (2014) found that the mandatory adoption of IFRS had a positive influence on firms' cost of debt. In their study on economic implications of IFRS, Daske *et al.* (2013) analysed the heterogeneity of companies studied on the way IFRS was implemented.

Having classified the adopting entities into label adopters, those companies that adopted the IFRS superficially in name but made no significant change to their reporting policies, they follow and observe serious adopters, companies that strategically adopted the international financial reporting standards with a commitment to promoting transparency. As expected, increased liquidity and decreased cost of capital were identified with the "serious adopters" category. This has positive economic implications.

Another call for further investigation into the economic implication of IFRS adoption is considering the heterogeneity of firms' operational and regulatory environment. Therefore, the adoption of IFRS does not produce equal beneficial effects to adopting entities; instead, it stirs up winners and losers' dichotomy among adopting firms. The effort of

different countries to adopt the presumed high-quality standard and the economic implications of this decision is still academically debatable, considering the mixed research results in the literature on the influence of IFRS adoption on the quality financial reporting. It is worthwhile that the impact of IFRS adoption on financial reporting quality is evaluated incorporating country-specific factors such as HDI, GDP and governance indicators in addition to firm-specific factors prevalent in the literature. This gives a broader picture of how the adoption of IFRS has influenced the quality of reported financial statements of firms in a country and how the macroeconomic variables of the countries have influenced the adoption of IFRS.

3.9 Adoption of IFRS: Perception of Users and Preparers of Financial Statements

Financial reports are often the basis upon which users make informed economic decisions. However, despite the increasing volume and complexity of financial reports as well as the revolution of capital markets, the relevance of financial statements to the recent financial crisis is questionable. This has made the reliability of financial statements an issue of academic debate. This section evaluates the perceptions of users of financial statements before the adoption of IFRS and how these have changed in line with their expectations in the operational environment on adoption.

3.9.1 Preparers and Internal users of Financial Statements

Financial reporting is a segment financial system of an organisation which provides a platform through which the organisation's performance can be evaluated. The timeline of reporting depends on the reporting requirements of users and the size and complexity of the reporting organisation. For instance, computerised accounting is more closely identified with large companies and has been argued to be very useful for internal reporting, such as management accounting. Although

the literature established that most large companies adopt IFRS, defining companies by size have been contentious. Where categorised quantitatively with established criteria of a country based on turnover or the number of employees, they may fall under SMEs as classified by the literature. Qualitative classification based on ownership structure or legal form often aligns with this.

The interview conducted by Mantzari (2013) with an auditor in a Greek setting reveals that Greek companies are considered small when using European criteria. However, they are considered 'very, very small' when using American classification. Companies used in this study are, therefore assumed to be large or medium-sized companies. Managers of companies rely on comprehensive and timely accounting information drawn from trial balances and cash flow budgets for operational decisions on the business. This might be periodical and often regular data sources such as monthly sales and operational expenses such as wages and salaries, the amounts due to creditors and those due from debtors. Through this management accounting information, financial plans for the company can be quickly drawn up.

In addition to this, budgets and expected sales can be easily estimated and business risk, pricing policy and cash flow forecasts become attainable feats. Usually, the estimated figures form the basis for comparison with actual results monthly, quarterly or annually for performance evaluation purposes.

The future economic direction of a firm can be predicted based on its annual or quarterly financial reports. Managers primarily rely on this for their economic decisions. The shareholders and chief financial officers of companies often evaluate balance sheet items such as liabilities (including loans) and assets including debtors, inventories and cash. However, the item that attracts most of their attention is the net profit, sales and cash flow as this enhances their creditworthiness

for high borrowings. According to Mantzari (2013), the focus of most users of financial statements is the 'bottom line'. He emphasised that statically analysing them is not as important as considering how they grow over the years.

Though the focus of managers and owners is usually getting the right and timely accounting information suitable for decision making, financial statements for external reporting showcase the image of the organisation and contribute vitally towards attracting funds from potential investors and other financial institutions. As financial institutions are strategic partners to organisations, the manager will do everything possible, including reporting high turnover, to ensure that the financial weakness of the organisation is not exposed in published financial statements.

This demonstrates the essence of the income statement in financial reports of companies despite IFRS standard-setters opting for the balance sheet-inclined model of financial reporting. Financial reports are indispensable for the sustainability and growth of the reporting entity as it mirrors companies in their business world. Therefore, to users of financial statements, the quantitative published accounting information is not more important than its qualitative version. Hence, by examining financial reports, the market position of a company, its prospects and value can be ascertained. This can be of importance in a take-over or acquisition bid where both quantitative figures and the qualitative value of the firm are assessed before the transaction is perfected.

3.9.2 Internal users and preparers of financial statements' perspective on IFRS adoption

In line with the perception of internal users and preparers of financial statements, preparing financial statements in line with IFRS has not significantly changed the way the administration of companies is done,

neither has it influenced decision making. Conversely, to a Chief Finance Officer, IFRS compliant reports help in structuring and organising the way accounting information is presented, thereby serving as a basis for seeing a more accurate picture of operational and transactional activities of the business. They further argue that adopting IFRS will always require the management team of the company to notify shareholders (this might be frequent) of any significant change in business decisions because the standard allows some flexibilities, unlike GAAP. However, although the adoption of IFRS has increased the administrative obligation of managers, no empirical evidence exists on whether it improves the quality of decisions made by the managers or not.

Given the increased importance of financial reporting in a company's economic activities, from the angle of the internal users, IFRS adoption has promoted self-awareness of companies' financial position and administration of their financial departments. Hence the adoption of IFRS could be viewed as a sanitation exercise into the accounting system of companies. It can also be perceived as a process through which a clearer view of the financial performance of companies can be evaluated. Nevertheless, this does not imply advocating new internal reporting systems, managerial practices, nor does it make companies duplicate their reporting activities. Adoption of IFRS focuses majorly on external financial reporting. Also, improved financial information embedded in IFRS inclined financial statement is not a guarantee for the best economic decision-making related to the business.

Furthermore, the transition to IFRS has an insignificant implication for practice and approach to management accounting. IFRS adoption also does not alter daily operational activities of the management, as their access to necessary information remains the same, whether under local standards or when IFRS was adopted. However, the approach has changed. Non-adopting countries, especially the emerging economies,

are trying their best to adopt international standards so as not to be left out of the ‘internationality’.

Preparing financial statements in line with IFRS has been argued to enhance communication between preparer companies and international institutions (like bankers, associate companies and credit insurance companies) that specialise in insuring and realising outstanding debts from suppliers. IFRS gives financial statements more credence and legibility in the eyes of international organisations. This has made the standard similar to a visa issued to the organisation for enlistment in international capital markets. IFRS-based financial statements reduce the workload and additional cost from duplication of financial statement preparation to meet the needs of different users. IFRS adoption has also been found to promote strategic alliance and cooperation among firms. The professed motive of financial reports preparation is to provide qualitative accounting information that would facilitate decisions on investment and good cash flow estimation. This aligns with IASB’s decision framework on financial reporting.

3.10 Review of Methodologies used in Prior Studies

Volumes of literature exist on the extent to which adoption of IFRS has impacted upon earnings management, and these have been variously methodologically carried out. According to earlier literature, the test of earnings management is a function of the normal accrual and earnings management model used (Klein, 2002; Guay *et al.*, 1996; Dechow *et al.*, 1995).

Studies on earnings management have been classified into accrual-based earnings management and real earnings management. Although accrual-based earnings management is prevalent in the literature, the recent trend demonstrates the relevance of real earnings management. The proponent of discretionary accrual is Jones (1991). However, this has been modified by several authors such as Dechow *et al.* (1995) and

Kothari *et al.* (2005). This study adopts the modified Jones model in calculating discretionary accruals, specifically Kothari *et al.* (2005) as used in Zeghal *et al.* (2011) because research has established it as being more suitable for a cross-country analysis (Gunther, 2011; Leuz *et al.*, 2003).

The Jones' (1991) model significantly impacted upon empirical accounting research. Xie (2001), having used the Jones (1991) model, found that ability to predict future earnings is lower in discretionary accruals than in normal accruals. Despite this, the Jones (1991) model is not without its flaws. It only explains approximately 10% of the deviation of the accruals (DeFond, 2010). The correlation between the residuals from the model and total accrual, as well as earnings performance, was found to be positive but negative with cash flow performance.

The implication of this is that estimating the discretionary accruals using the Jones (1991) model resulted in the correlated omitted variable problem. Dechow *et al.* (1995) formally illustrated this. Having undergone a direct test of earnings management, they observed that Jones (1991) omitted some essential regressors in her analysis. This omitted variable problem could lead to Type I and II errors. That is a failure to accept the null hypothesis that firms are not involved in earnings management and accepting the alternative hypothesis that firms indulge in earnings management.

Testing for earnings management is a function of the model used by the researchers in establishing discretionary accruals (Kothari *et al.*, 2005). This has led to different estimation procedures and debate by various authors adopting the approach. Based on the deficiencies of the Jones (1991) model, and the necessity for a representative proxy that can adequately capture earnings management, several authors in their methodologies have presented their view on how better earnings

management can be measured. Further discourse on earnings management models is explored in the methodology chapter. However, below is the tabular presentation of these models used in measuring earnings management in chronological order.

<i>Model</i>	<i>Expression of Equation</i>	<i>Notes</i>
<i>Jones Model</i>		
Jones (1991)	$\frac{TAt}{TAt - 1}$ $= \beta_0 + \beta_1 \frac{(\Delta REV_t)}{TAt - 1}$ $+ \beta_2 \left(\frac{PPE_t}{TAt - 1} \right) + \varepsilon_t$	Change in sales (ΔREV_t) and property plant and equipment (PPE) lagged by the beginning of the period's assets (A_{t-1}) are used in deriving normal accruals cross-sectionally.
<i>Modified Jones model</i>		
Dechow <i>et al.</i> (1995)	$\frac{TAt}{TAt - 1}$ $= \beta_0 + \frac{1}{TAt - 1}$ $+ \beta_1 \frac{(\Delta REV_t - \Delta RECT)}{TAt - 1}$ $+ \beta_2 \left(\frac{PPE_t}{TAt - 1} \right) + \varepsilon_t$	Sharing some similarity with the Jones (1991) model except the inclusion of the change in accounts receivable scaled by lagged total assets in the model on the presumption that earnings management is likely going to be effected on revenues.
<p><i>All variables are defined as in the Jones (1991) model; $\Delta RECT$ is net receivables in year t less net receivables in year $t-1$</i></p>		
<i>Abnormal Working capital</i>		This model is preferred when the number of years/industry

accruals DeFond and Park (2001)	$AWCA_t = WC_t - \left(\frac{WC_{t-1}}{S_{t-1}} \right) \times S_t$	<p>observations is limited. (Wysocki, 2004). Working capital WC, the non-cash working capital accruals are calculated by subtracting cash and short-term investments from current assets and subtracting current liabilities after excluding the short-term debt from the result. S is the turnover/sales for the year</p>
Cash flow-based accruals model Dechow and Dichev (2002)	$Tacc_t = \beta_0 + \beta_1 CF_{t-1} + \beta_2 CF_t + \beta CF_{t+1} + \varepsilon_t$	<p>Total accruals are derived by deducting cash flows from net income; normal accruals are expressed in a manner that reflects the timing of the cash flow (i.e. as a function of past, present and future cash flows).</p>
Performance matched accruals model Kothari et al. (2005)	$DisACCA_{jt} = DisACC_{it} - MatchDisACC_{it}$	<p>This model correlates performance with residuals by matching observation on discretionary accruals (<i>DisACC_{it}</i>) with observations on discretionary accruals from a firm in a similar industry having the closest Return on Assets (ROA) (<i>Match_DisACC_{it}</i>)</p>
Non-linear discretionary		<p>Non-linear accruals model builds on Dechow and Dichev (2002) model but inculcating the</p>

<i>accruals model</i>	ACC_t	asymmetric	timeliness	of
	$= \beta_0 + \beta_1 CF_t + \beta_2 CF_{t-1}$	Earnings.	Accruals	are
Ball and Shivakumar	$+ \beta_3 CF_{t+1} + \beta_4 DCF_t$			
	$+ \beta_5 DCF_t CF_t + \varepsilon_t$			
(2006)				
				independently related to losses in comparison to gains. The model gives a more detailed explanation of variation in accruals than similar linear stipulations.

Table 2.2 A Review of Earnings Management Measures Used in the Literature

Source: *Author's compilation*

3.11 IFRS Adoption and Earnings Management

The literature documents some studies on the relationship that subsists between IFRS adoption and earnings management and, in some studies, IFRS and accounting information quality. For instance, Kao and Wei (2014) find that IFRS improves the value relevance of financial statements, but its influence on the reliability of such is not statistically significant. In a comparative study of the pre-IFRS adoption period and the post-IFRS adoption period of three countries (UK, Australia and France) Jeanjean and Stolowy (2008) observed that adoption of IFRS does not reduce EM in all the countries. France was found to have a higher incidence. Atwood *et al.* (2011), in their comparative study of IFRS and US-GAAP, also observe persistent profits are higher than persistent losses under IFRS. The study by Van der Meulen *et al.* (2007) finds that there is a disparity in the extent of the predictive power of the US GAAP and IFRS over earnings.

Examining the impact of the transition from Greece GAAP to IFRS through the analysis of financial reports of publicly listed firms in Greece, Iatridis and Rouvolis (2010) find that transition-related costs to IFRS adoption contain EM. The impact is more adversely felt in the

first year of adoption. Notwithstanding, the financial policies of firms were enhanced. Evidence from Sweden by Hellman (2011) studying the voluntary adoption of IFRS and reporting incentives of firms argue that firms that adopted IFRS before 2005 (voluntary adopters) exploited the flexibility the principle-based standard offers by engaging in discretionary EM. This resulted in increased shareholder equity.

The principle-based nature of IFRS has been criticised for encouraging EM. Furthermore, the global applicability of IFRS will encourage flexibility in the standards (Haller and Eierle, 2004). This is likely to encourage opportunistic EM by managers while applying the IFRS (Dye and Sunder 2001). Following the fact that the research results on the influence of IFRS adoption on EM in the literature are inconclusive, Ball *et al.* (2000) and Li (2010) accord the efficacy of IFRS in curbing earnings management to the vitality of the judicial and legal systems of a country. By my expectation, where good enforcement is in place, the quality accounting standard should improve the quality of financial reports on the premise on which they are prepared.

Arguments exist in the literature on whether the adoption of IFRS guarantees reliable financial reports. There are two views on this. First, a school of thought believes that high-quality financial reports can ensue from the adoption of the IFRS, provided institutional structures and strict enforcement allow an excellent platform for such (Jeanjean and Stolowy, 2008). According to Leuz *et al.* (2003), while protecting shareholders' interests, the insider's ability to acquire private information is often restricted. This will, in turn, reduce the motives of managers to conceal real economic performance of the firm. In addition to this, Lang *et al.* (2006) argued that despite the adoption of common accounting standards, the financial results of cross-listed European companies and US firms are not comparable.

Earnings management is also perceived to be more rampant among non-US firms than in US-based companies. In the words of the American Accounting Association, the institutional differences across countries “*will likely result in differences in the implementation of any single set of standards. Thus, IFRS may be a high-quality set of reporting standards (pre-implementation) but the resulting, published financial statement information could be of low quality given inconsistent cross-border implementation practices*” (Financial Reporting Policy Committee, 2007).

Secondly, the argument on comparability and transparency emphasised that accounting quality should improve. However, the reality of institutional factors and managerial motives implies that the effect of the mandatory adoption of IFRS is adverse. Countries with good institutional structures and stricter law enforcement systems before the advent of IFRS are presumed to experience little impact on their accounting quality. This explains why some research findings establish that the adoption of IFRS improves the value relevance of financial statements of firms, ignoring the institutional structures in place that provide the enabling environment for this.

Several empirical studies exist on the implication of transition from GAAP to IFRS and harmonisation of accounting standards among countries. However, the relationship between IFRS adoption and the quality of financial reports and its net impact remains uncertain. Daske *et al.* (2007b) studied the economic consequences for 3,800 early adopters of IFRS firms from 26 countries. The analysis considers the effect of IFRS adoption on market liquidity, Tobin q and cost of equity. Their results emphasised an increase in equity valuation and market liquidity at the time IFRS was adopted. In addition to this, Barth *et al.* (2008) examined the accounting quality of 327 firms in the period between 1994 and 2003. The findings of Barth *et al.* (2008) on the 1,896 observation study revealed that reduced earnings management is more

closely identified with IFRS adoption period than the pre-adoption period. They also discovered increased value relevance and more prompt recognition of losses, unlike during the period of local GAAPs.

Having observed 16 events that may affect the reality of adoption of IFRS between the period of 2002 and 2005, Armstrong *et al.* (2007) find that the relationship between the stock market and the influencing event on the likelihood of IFRS adoption is significantly positive. They also added that this reaction, for companies that do not cross-list in the United States was stronger. The inference that can be drawn from these findings is that firms that adopted IFRS early enough benefited from it. Based on this, this research intends to establish the relationship that exists between IFRS adoption and EM, incorporating firm-specific variables and country-level variables.

3.12 The Big Four and Accounting Quality

There are mixed findings in the literature regarding the impact of IFRS adoption among countries. Likewise, mixed findings exist on whether the engagement of any of the Big Fours enhances the quality of accounting earnings or not. Yasar (2013) argues that engagement or non-engagement of the Big Four does not reduce the extent of earnings management practised by Turkish firms. This is consistent with studies from similar sets of emerging economies such as Korea (Jeong and Rho, 2004; Park *et al.*, 1999) and Greece (Tsipouridou and Spathis, 2012).

However, studies conducted in developed countries presented different results (Teoh and Wong, 1993; Becker *et al.*, 1998). This study takes this further by evaluating how the engagement of the Big Four has contributed to reported earnings quality, especially on the adoption of the IFRS. Consistent with the literature, this research uses the Big Four as a measure of audit quality, while the modified Jones discretionary accrual is used as a measure of earnings management. The literature also established the impact of auditing firms on earnings management

and the adoption of IFRS. Hence, the next section explores the roles of audit firms, especially the Big Four, in the implementation of IFRS and promotion of the quality of reported earnings.

While researching earnings management using accounting choices and operational decisions as proxies, Martinez (2009) found that the Big Four audit firms do not reduce engagement with earnings management, apart from instances as induced by managers on operational decisions. The research was carried out on Brazilian public companies in the period between 1998 and 2005. However, he observed reduced earnings management on the engagement of the Big Fours, based on accounting choices. Similarly, the findings of Almeida and Almeida (2009) reveal that companies whose accounts are audited by the Big Fours are found to have lower levels of discretionary accrual than companies audited by non-Big-Four firms.

Therefore, they conclude that the Big Four show evidence of minimising earnings management as practised by managers. Silva and Bezerra (2010) having studied 25 companies in the period between 2000 and 2008 found that a change in a firm auditor can lead to reduced earnings management. In the same vein, Martinez and Reiz (2010) studied the association between rotation procedures of audit firms and earnings management among Brazilian public listed companies for 1997 and 2007. The finding revealed that audit rotation has no significant effect on earnings management.

In the Greek context, Tsipouridou and Spathis (2012) did a study on whether auditing encourages opportunist earnings management on the adoption of IFRS, but could not find the differential impact of engaging the Big Four audit firm or other audit firms on earnings management. The findings of Ghosh *et al.* (2010) and Joubert and Fakhfakh (2012) revealed that financial statements audited by any of the Big Four audit firms often limit earnings management. Therefore, in this vein, this

thesis assumes that financial reporting quality proxied on reduced earnings management is a product of the quality audit. Hence it is further assumed that engaging any of the Big Four firms will enhance the quality of published financial statements. This, in turn, enhances the reliability of accounting information for informed economic decision-making by users. Therefore, among other things, this thesis evaluates the influence of engagement of any of the Big Four audit firms in promoting financial statement reliability through reduced earnings management, primarily on the adoption of the IFRS. Also, a further enquiry will be made as to whether the differences in prior results were due to diversities in the institutional features of countries of study.

Although IFRS is a single uniform standard, each country differs in its accounting culture and traditions. The social, legal and political systems are nevertheless the same. This has thus made the application of IFRS challenging for adopting countries. Other factors influencing the practice of accountancy in countries also include the providers of finance, the association between accounting and taxation and the type of legal system in force in the country. These have a substantial effect on the accounting practices of countries (Alexander *et al.*, 2006; Nobes and Parker, 2008). This has triggered a research enquiry as to whether IFRS is a “one dose cures all” standards as far as enhancing earnings quality of adopting countries is concerned. According to Delvaile *et al.* (2005), France, Germany and Italy, although to some extent are similar in their accounting models - differ in their accounting practices and how individual countries apply the IFRS is not the same. This has made accounting convergence based on IFRS adoption a complicated and slow project. However, the Big Four firms have been playing a significant role in this regard.

According to Albu and Albu (2011), auditing is defined as “*a politically neutral technique of verifying the accounts*”. There is a dearth of literature on the political and economic consequences of this process.

Hence this thesis, among other things, intends to evaluate how the Big Four have contributed to the enhancement of accounting information quality and their contribution in promoting IFRS adoption. The evaluation is done for both developed and emerging economies. This builds on Humphrey *et al.* (2009) and Sikka (2009) who evaluated the audit process with a particular focus on the Big Four during the period of global financial crises. In addition to this need for further research on the area, this research intends to contribute to the literature by exploring the roles of the Big Four during IFRS implementation especially in emerging economies characterised by poor accounting systems and lack of technical expertise.

Auditing is a mechanism of control to enhance the credibility of the financial status of a reporting company. The audit process has been argued to minimise agency costs from an economic perspective, and from a social perspective is a social mechanism of control (Richard, 2006). According to the literature, auditors are variously referred to by different names. For instance, as a referee, ‘guardian of trust’ (idem: 155) or watchdogs (Reckers *et al.*, 2007). The emergence of the Big Four has further promoted the internationalisation of auditing. The origin of auditing and emergence of the Big Four firms have been traced to one single source - the Anglo-Saxon countries (Albu and Albu, 2011). They were first referred to as the Big Eight in 1960 in a publication called ‘Fortune’. These firms are the largest audit firms of their time. Consequent to the several mergers that were consummated in the 1990s, they reduced to Big Five.

The demise of Arthur Andersen, after Enron’s fall, further reduced the Big Five to the Big Four (Deloitte, Touche Tohmatsu, Ernst and Young, KPMG and PricewaterhouseCoopers). These auditing firms are perceived as catalysts for growth, profitability and internationalisation (Zeff, 2003). Although mostly engaged by big companies, they are apt to identify and implement changes in accounting and audit practices.

The demand for their services is now changing due to internationalisation from core auditing to auditing and consultancy. However, the ratio between auditing and consultancy services rendered by auditing firms, especially since the advent of the IFRS, has been an academic debate. Nevertheless, this has led to more turbidity of the Big Four (See Zeff, 2003a, 2003b and Klarskov Jeppensen, 1998).

Initially, there was a clear-cut distinction between the roles of accountants in auditing and consulting services. While auditors are to carry out independent examination on the financial statements about truth and fairness, consultancy service is about the mutual benefits of both the auditee and the auditor. However, independent status is at stake as the auditee's success is also the success of the consultant. In a bid to provide value-added services to their clients the Big Four firms strategically include in their services some value-added audit services such as nearness to clients and adaptation of audit processes to the needs of their client (Klarskov Jeppensen, 1998). These have been threats to auditors' ethical standing and independence. The Big Six formerly referred to as the Big Eight were, despite their size, credited for audit professionalism in the early 90s. However, the pressure from their clients is changing their function from audit to consultancy and audit (Albu and Albu, 2011).

According to Klarskov Jeppensen (1998), audit transforms into a commodity because, since the 1970s, the strategy of the big firms changed due to heightened competition faced by their clients leading to an increase in their expectations. In response to this, the big firms changed their audit approach to a new one such as risk-based audit in the 1980s, by establishing financial goals and adopting a business approach. For instance, as published on the website of the KPMG in 1997 (idem: 521), the change in audit approach of the firm was triggered based on the statement below

“... clients are asking for an audit that does more than look at numbers.”

Firms now want to know how their performance compares against industry best practices. Also, they are more interested in potential risk that might adversely affect their business. They also have a high expectation that their auditors, being professionals, would be of great help in this regard by providing necessary information to the decision makers. These developments significantly influenced big audit firms' independence, the quality of audit reports, competence and the modification in the auditor to auditee relationship.

3.12.1 The Role Played by the Big Four during Implementation of IFRS.

The fundamental roles of the Big Four accounting firms include their involvement in standard setting and the development of guidance for its implementation (Tokar, 2005). This is common in Anglo-Saxon countries. For instance, a right proportion of IASB's members are large accounting firms, who also make a major financial contribution to the IASB (Brown, 2004). Considering the independence of the IASB due to the financing role of the Big Four, this translates into the division of standard-setting procedures being the office of IASB while the financing roles are held by the IFRS Foundation.

Enhancing uniformity in the interpretation of subject matters raised during IFRS implementation makes the big accounting firms develop working groups in countries even beyond national offices where they are domiciled (Tokar, 2005; Hoogendoorn, 2006). Acknowledging that IFRS can be variously interpreted due to cultural factors and country inclined features, Tokar (2005) argued that her accounting firm trains its staff to be IFRS-focused and avoid being distracted by diversities in its interpretation.

Since the expectation of the market and securities regulatory bodies is to have, from the Big Four, a uniform standard of the same interpretation as far as IFRS implementation is concerned, this led to significant pressure on the Big Four accounting firms (Hoogendoorn, 2006). Consequently, this provoked actions to devise a single solution to different interpretations of accounting standards, especially between rule-based national standards and principle-based IFRS. Interpretation is always the issue with the latter. Due to the confinement of national training to national regulations and legislation, the Big Four also facilitate training on IFRS and pride themselves as a mediator of IFRS implementation worldwide (Tokar, 2005). Occasionally, there is a tendency to interfering with the application of the IFRS by their clients. According to Hoogendoorn (2006), in a bid to encourage their clients to adopt the IFRS, the auditors are profoundly involved to the extent of preparing the financial statements they are supposed to audit independently.

3.12.2 The Independence and Competence of the Big Four during the Implementation of the IFRS.

The Big Four audit firms create a stable platform for innovations, standardisation and regulations of accounting practices. This also serves as a forum for the translation of rules and standards into practices, and for networking among professionals (Cooper and Robson, 2006). Brown and Tarca (2005) also described auditors as enforcement machinery for implementation of IFRS. A useful application of IFRS demands reasonable control and management systems, independent and IFRS compliant auditors and regulatory bodies. However, this can only be achieved where the role of auditors as enforcement agencies does not conflict with their independence and competence. The general notion is that auditors' independence is paramount to their competence, just as their competence is vital to their independence. In this light, Richard (2006) argued that auditors should

strive to strike a balance between their independence and competence. He further stated that though the Big Four firms are highly competent and their clients desire to have a good collaboration with them.

While acting in the capacity of both auditor and consultant, an auditor becomes both an insider and an outsider. The purpose of acting as an insider is to carry out their task as an outsider efficiently. As stated by a manager, auditors' technical skills and ideas are often sought after. They are believed to have the technical knowledge of the entity they are auditing and are thus expected to provide clues to business issues, tapping from their wealth of experiences in the industry as related to the situation at hand.

The issues regarding the professional position, approach to duties and the relationship subsisting between auditors and their clients depend on their mutual expectations. Auditors' competence and independence are issues of interest in emerging economies. The prevalence of corruption, the existence of weak accounting systems, lack of technical expertise and the desire to attract foreign capital from developed economies have made published financial statements prone to earnings management.

Due to their involvement in setting international accounting standards and, sometimes, local standards and structuring and re-organising the accounting profession, the Big Four have the opportunity to create a niche for themselves (Kirsch *et al.*, 2000). Apart from establishing their branches in countries, they also encourage Anglo-Saxon accounting orientation in their systems. Hence, the big audit firms contribute significantly towards the reformation of the accounting system from local standards towards international standards for most emerging economies (Delesalle and Delesalle, 2000). According to extant literature, an auditor's prior concern is to maintain their clients; this thus causes them to be perceived as being less independent. Therefore, the preparers, professional bodies and users of financial statements often

consider the Big Four to be more independent than local firms (Cooper and Robson, 2006).

Sucher and Jindrichovska, (2004) on a study on large companies in the Czech Republic audited by any of the Big Four, pre-tested the IFRS before their decision to finally implement the standard. Their findings revealed that these companies, through the support of the Big Four audit firms, have set their calendar to adopt the IFRS. Conversely, companies being audited by local firms did not set the calendar for the implementation of IFRS; neither did they have plan training to pre-test it.

Although the IFRS was well accepted by large firms and foreign investors of these countries, they nevertheless sought support from the Big Four. This might be because of adequate skilled personnel needed to appropriate the right policies to be adopted in the implementation, especially in the preparation of financial statements. Given the financial strength and investment of the Big Four to ensuring their competencies in the IFRS, it is imperative that auditors undertake the implementation journey with their clients for a good result. As noted by Sucher and Jindrichovska (2004), where there are occasions for IFRS reporting, the Big Four audit firms prepare the financial statements they will eventually audit.

Also, worthy of mentioning is the relevance of auditors about taxation and its effects on financial statements. Traditionally, the role of auditors is to report on the truth and fairness of financial statements in compliance with the relevant financial reporting framework (European Commission, 2010). However, clients may also desire that the auditor renders some consultancy services to them, such as taxation issues. This calls for their conformity with both accounting and taxation regulations. The auditor could thus act as a ‘financial lawyer’ of the company that engaged them while dealing with the tax authority.

The relationship between the Big Four and their clients is, therefore, based on their status and competence. A survey carried out by Albu and Albu (2011) documents that although some companies prepare their accounts in line with the IFRS, auditors often help them to do that in congruence with their national regulations. This includes accounting for impairment of property, plant and equipment. They also found that in practice the value in use does not accord as much importance as disclosure of the impairment (*idem*). Establishing the value in use in practice is a difficult task. It requires the engagement of an independent valuer for the impairment to be reasonably established and accounted for. Hence, in that case, the auditor will have no reservation. The findings of Sucher and Jindrichovska (2004) also support this. As noted in prior research, auditors often serve as motivators to companies as far as appraising assets value, and impairment recognition is concerned. It is hard seeing companies doing it by their intuition.

Hence the role of the Big Four in enhancing probity in the application of accounting policies has caused a paradigm shift of these firms from being a singular service provider (such as tax advisers) to being user-centred in their service delivery. Some financial managers and accountants are not technically equipped on the IFRS. The technical know-how of the auditor will, therefore, create an opportunity they can benefit from at the expense of the reporting firms (Sucher and Jindrichovska, 2004).

The role played by Big Four auditors during IFRS implementation has placed them in the position to showcase their competence in ensuring that client firms are better disposed to the application of accounting policies to attract investors, gain public acceptance and for their financial enhancements.

3.13 Summary

This chapter reviewed prior studies on IFRS and earnings management. It also addressed the conceptual framework toward achieving the research objectives. It laid the foundation for the methodology chapter by reviewing the types of accrual-based earnings management used in prior studies. The chapter concludes with the role of the big four in the adoption and the implementation of the IFRS. It is worthy of studying because auditors, the big four in this case, are banked upon for the reliability of the published financial statement. Furthermore, IFRS is also towards enhancing the quality of reported earnings. The interactive effect of the two variables on earnings management is evaluated in chapter six. The next chapter explore the theoretical framework for this study. It further discusses the development of hypotheses.

Chapter Four: Theoretical Framework and Hypothesis Development.

4.0 Introduction

This research is based on two core variables: international accounting standards and earnings management. Due to the nature and purpose of this research, this section reviews the principal theories on which this study anchor: agency theory, institutional theory, contingency theory, isomorphism and signalling theory. This chapter also discusses the firm-specific and country inclined variables as well as the hypotheses developed from them.

4.1 Agency Theory and IFRS adoption

Financial statements provide the basis on which investors make informed investment decisions. Hence, managers will be motivated in managing earnings by reporting the financial results of their companies in a better and more consistent way to influence market share prices and reduce instability of earnings (Dye, 1988; Healy and Wahlen, 1999; Trueman and Titman, 1988). Although managers esteem shareholders and potential investors in preparing the financial statements in line with the standards, they might manage the earnings and other financial information to achieve their desired contractual results (Duru and Tsitinidis, 2013; Kellogg, 1991). Ownership structure has also been reported in the literature as an influencing factor in the risk of having financial statements manipulated (Duru and Tsitinidis, 2013). The financial reporting role of managers is an offshoot of the principal to agent contractual relationship that the separation of the parties' roles affords. It is also a control system of limiting earnings smoothing. This is what agency theory proclaims (Eilifsen, *et al.*, 2010).

The conflict of interest that could arise from unequal access to a firm's information between managers (agents) and shareholders (principals) is

a primary concern in the application of agency theory. This could also occur where agents take some decisions that are not in the owners' best interest, while financial statements are being prepared (Fama and Jensen, 1983). However, according to Callao and Jarne (2010), misrepresentation of accounting information can be restrained through the application of accounting standards.

While the rigidity that local GAAPs and IAS afford are said to limit opportunistic behaviour of managers to earnings management, the flexible nature of IFRS has been criticised for enhancing the managerial discretionary opportunity to manage earnings (Burgstahler and Dichev, 1997). The greater the flexibility of the accounting rules, the higher the tendency to financial statements being manipulated. This is a long debated academic issue on which mixed findings ensued (Callao and Jarne, 2010; Jeanjean and Stolowy, 2008).

The tendency of IFRS adoption being effective in enhancing the financial reporting quality of firms is one of the underlying assumptions of agency theory. After the adoption of IFRS in 2005, European Union stock markets demanded that member states have a new reporting system, thus enhancing uniformity in the presentation of financial statements. Some authors have argued in favour of IFRS that it has the capacity of bridging the gaps caused by differences in accounting regulations in different countries of the world by providing the basis of measurement and recognition of financial transactions which local standards have not treated (Daske *et al.*, 2008; Ball, 2006; Dao, 2005; Ball *et al.*, 2003). Other authors view IFRS as encouraging information asymmetry between internal users and external users because of the elaborate disclosure requirements demanded by IFRS, contrary to local GAAPs (Iatridis, 2010; Healy and Palepu, 2001).

Conversely, evidence exists in the literature on how the adoption of IFRS has negatively influenced financial reporting quality (Ormrod and

Taylor, 2004). Points raised are the flexibility of the principle based IFRS compared to local standards, which are rule-based. Another issue raised is setting the basis for fair value accounting and having the requirements for published financial statements reduced (Trussel and Rose, 2009). The reasons for these issues against IFRS are its provision of motivation that encourages opportunistic discretionary accounting. Also, there is the tendency of having increased extents of discretionary accounting at the initial stage of IFRS adoption; unlike in local GAAPs, which envisage the peculiarity of the impending challenges in interpreting accounting standards (Laux and Leuz, 2009; Arnold, 2009; Pozen, 2009).

4.2 Institutional Theory and Isomorphism

The proponents of institutional theory emphasised the essence of legitimacy and gaining social acceptability of the international accounting standards by affected parties, even if there is a potential indication of this being inappropriately applied (Carpenter and Feroz, 2001). On this premise, the proponents of institutional theory have criticised the adoption of IFRS and its implementation on the technical grounds of not reflecting the cultural and political characteristics of adopting countries. They also argue that firms often adopt the IAS/IFRS not only on the quality of the standard alone, but usually to boost the image of their organisations. This is usually motivated by their rationality to be viewed as responsible, modern and law-abiding firms (Rodrigues and Craig, 2007; Carruthers, 1995; Meyer and Rowan, 1977). This is also applicable to countries. They would like to flow in the direction of the dynamism of the accounting profession and avoid being inferior to other countries that have adopted the standard.

Institutional theory is fundamentally based on the premise that all organisations incline to align with accepted norms and social influences. Failure to do this will result in losing their legitimacy and

might affect their image (Carruthers, 1995; DiMaggio and Powell, 1983). Hence, the need for a common platform for organisational structures and practices has enhanced convergence. The implication of this for IFRS adoption is that IFRS-inclined published financial statements will receive global investors' recognition, especially in the international financial markets rather than those prepared using local standards.

The institutional theory is also valuable in explaining developments in international accounting over time. This theory negates the adoption of formal structures and procedures by organisations, making them produce the same old results. In the words of Rodrigues and Craig (2007), "*The common myth is that a formally announced practice of an organisation (e.g. steadfast total compliance with IFRS) does not differ from its actual, or informal practice (e.g. less than 100% adherence to IFRS)*". This difference between formal and informal structure and practices is described figuratively as *decoupling*. The benefit of decoupling is its ability to allow potential irregularities and anomalies of technical activities (such as accounting) to remain hidden, on the assumption that the formal structure is working as specified openly. Although it may be claimed that formal structures and systems are in place, they might be window-dressing to entice users of financial information.

Accordingly, the institutional theory has these variants: structural isomorphism, where organisations' structure transforms into others'. However, this may not improve their efficiency (DiMaggio and Powell, 1983). Pertinent also is a competitive isomorphism. Every rational being looks for the best and cheapest way of getting things done. Thus, by permitting a free and open market competition, competitive isomorphism enhances efficiency. This involves free and open market competition scenarios based on conceptions of efficiency. When organisations desire to do things efficiently, they are propelled by the

competitive force while seeking the cheapest and best way of getting things done (Carruthers, 1995; DiMaggio and Powell, 1983).

The last is institutional isomorphism: this is the common consensus reached by organisations in response to similar industrial pressures, thus motivating them to adopt the same practices among themselves (DiMaggio and Powell, 1983). Institutional isomorphism makes organisations conscious of what is going on in their industry (Aldrich, 1979; DiMaggio and Powell, 1983). Hence, the isomorphism theory is a fundamental aspect of the institutional theory.

Until recently, the term ‘isomorphism’, has been a common term in biology, chemistry and mathematics. Isomorphism is now used in business and organisational contexts, especially in accounting. According to Merriam-Webster online Dictionary, (n.d.), isomorphism could be defined as *“a similarity in organisms of different ancestry resulting from convergence”*. In the words of Rodrigues and Craig (2007), *“Isomorphism describes a process whereby one organisation (or set of institutional arrangements, such as international accounting standards) becomes like another organisation (or set of institutional arrangements) by adopting (or moving closer to) the characteristics of the other organisation”*. On this basis, the literature evidences the loose use of the term to connote convergence as used in most accounting research today, especially in this era of IFRS adoption.

When an organisation adopts the legitimate and socially acceptable structure and management practices of another in their field, their real usefulness notwithstanding, isomorphism is assumed to have been initiated. Contextually, this applies to countries whose accounting standards, regulations and practices rhyme with other countries’.

Further, the common grounds that enhance isomorphism can also be geographical proximity as, for instance, in the EU and the Association of South East Asian Nations [ASEAN], religion or bilateral agreements

(for example between Canada and USA) (Saudagaran and Diga, 1997; Rodrigue and Craig, 2007).

Some situations may motivate organisations into changing their accounting and financial reporting practices as influenced by isomorphism (Scott, 1987). DiMaggio and Powell (1983) point out three essential forms of institutional isomorphism which principally border on transmitting legal accounting practices. These are *coercive*, *mimetic* and *normative* isomorphism (Carpenter and Feroz, 2001).

Coercive isomorphism: this relates to the response of the organisation to external pressure to which it is subject. For instance, pressure from an organisation on which it is dependent or with whom it has a general cultural expectation in common (Carruthers, 1995).

Mimetic isomorphism: This happens when an organisation emulates the actions of a similar, legitimate and successful organisation to be more legitimate and successful in its operational environment.

Normative isomorphism: This identifies individuals in a similar line of business or within a profession to encourage an intellectual base, popularise shared orientations and organisational practices, and legitimise their operations (DiMaggio and Powell, 1983).

According to DiMaggio and Powell, (1983), normative isomorphism can be developed through formal education or professional systems. Normative isomorphism is enhanced by how each profession trains and inducts its members. The process of certification and accreditation of courses in educational institutions to members are also relevant.

From the perspective of the International Financial Reporting Standards (IFRS), institutional theory can be described as a social process that promotes the transition from national accounting standards to international accounting harmonisation from the perspective of their national accounting standards. For instance, the accounting standards

of Portugal now share more similarities with the IFRS than was the case 30 years ago. Using a sample of 43 accounting issues, Fontes *et al.* (2005) found that the Jaccard's coefficient was 50% on the convergence of Portuguese to international accounting standards. However, it was 9% in 1977. The isomorphism theory provides a basis for testing the influence that adoption of IFRS might have on financial reporting quality. In this research, reduced earnings management is assumed to vary proportionately to the increased quality of earnings management. Hence, this study examines the experience of adopting companies in emerging economies to evaluate the tendency that countries that have not adopted could adopt the standard due to isomorphic forces.

4.3 Contingency Theory⁹ and Earnings Management.

Prior studies have established the importance of the quantity and quality of accounting information to the economic and human development of countries globally (Belkaoui and Masky, 1985; La Porta *et al.*, 1999; Riahi-Belkaoui, 1995, 1996, 1998, 1999). However, one of the challenges to the quality of financial reports is earnings management. When the reported earnings of a firm do not reflect its real status and economic performance, the account is perceived to be 'managed'.

The wholesale adoption of the uniform standards - IFRS - among countries despite differences in their culture, economic status and legal system could be challenging in its bid to enhance financial reporting quality. The literature documents the evidence of earnings management among developed economies, despite the soundness of their financial systems (Gunther, 2011; Zeghal *et al.*, 2011). It has also been argued that earnings management is prevalent among emerging economies due to weak financial reporting systems (Rudra and Bhattacharjee, 2012; Shen and Chih, 2005; Bartov *et al.*, 2004). Hence, earnings

⁹ Further information in note 22

management is a global phenomenon, just as IFRS is of global relevance.

However, the manner and approach to earnings management differ from one country to another, just as the principles-based nature of IFRS has given managers discretion to choose an area of least resistance in reporting their financial activities. Given the increasing popularity of IFRS among countries, it is, therefore, worthwhile to examine its impact in countries of differing economic status. This has led to identifying the relevance of contingency theory in this regard.

Fiedler (1964) propounded the contingency theory. He emphasised that effective leadership styles will rely upon the setting to which its application relates. Having studied the potency of positional power attached to a leadership position, the relationship that subsists at workplaces and the structure a task may involve, he opines that leadership style could either be task motivated or relationship motivated. In other words, the three factors must be considered while recommending the leadership style that matches up with a position. Fiedler viewed leadership style as an intrinsic feature of a leader that has been precisely and consistently used while in position.

Contingency theory was made famous by Lawrence and Lorsch (1967). Building on Fiedler (1964), they visualise contingency theory as a concept that explains organisation variation and integration as influenced by environmental factors. It is traceable to the heuristic concept that opposes managers' inclination to approve universalistic solutions and to peddle panaceas (Nnandi *et al.*, 2015). The contingency theory claims that organising a corporation, leading a company and making decisions have no one best way of being accomplished. It also explains the difference in the structures and process of how things are done in the organisation from the angles of the operational environment, size, culture, technology and strategy, to mention a few (Nnadi *et al.*,

2015; Scott, 1987). The best course of action is thus conditional upon both the internal and external settings of the situation. Therefore, a contingent leader is a leader who could apply his leadership style as demanded by the situation.

Although contingency theory has been variously applied in many fields including science and management, from a broader perspective, its philosophy of “no one best way” has made it explicitly relevant to accounting research. The literature also evidenced its application in the following branches of accountancy: financial reporting (Thomas, 1991; Xiao *et al.*, 1996), management accounting (Otley, 1980; Hopwood, 1983; Gul and Chia, 1994), accounting education (Lopez Gavira and Omoteso, 2013), auditing (Omoteso, 2013), accounting ethics (Schweikart, 1992) and government accounting (Luder, 1992; Gupta and Dirsmith, 1994).

The relevance of this theory lies in three fundamental principles which are all applicable to the adoption of IFRS and earnings management (Nnadi *et al.*, 2015; Bartol and Martin, 1994 and Scott, 1987). The principles are:

- i. there exists no single best way of organising a thing or phenomenon;
- ii. the different way to organise is not operational in the same way;
- iii. the best way to organise is dependent on the nature of the environment from which the organisation operates.

Logically, IFRS could be good at enhancing financial reporting quality; its principle-based nature could trigger managers to use their discretion based on contingent factors that their operational environments breed. According to Bhattacharya *et al.* (2002), differences in the level of earnings management among countries are traceable to environmental factors (social, religious, political, legal and economic) which in turn

impact the economic welfare of countries. Also, factors such as culture, political system and economic growth have been established to be core factors that influence the decision to adopt IAS (Al-Akra *et al.*, 2009; Zeghal and Mhedhbi 2006; Larson, 1993).

The findings of Zehri and Abdelbaki (2013) revealed that political system, culture and existence of a capital market do not significantly influence the adoption of IFRS. They assert the economic growth level as being a unique determinant. Therefore, one of the objectives that this thesis intends to achieve is, based on international contingency theory, to assess empirically how the economic status (development) of a country influences the vibrancy of the IFRS in promoting financial reporting quality. The measures used to capture this at each country level are the Human Development Index (HDI) and the growth rate in the gross domestic product (GDP)¹⁰.

As this study is a cross-country study, contingency theory provides the best platform for understanding the contingent factors that could affect financial reporting quality among listed companies in their respective countries on the adoption of the IFRS. While the standard setter intends to promote uniformity, transparency and financial reporting quality among countries of the world, the question is whether the uniform standard can have free course given the peculiar features of each country and its economic status. The contingency perspective contributes by showing that a partial adoption can be detrimental due to the potential conflation of accounting practices in a national context.

4.4 Signalling Theory and Earnings Management.

Signalling theory was propounded by Akerlof (1970). It describes a situation where two parties, the sender and the receiver of the signal

¹⁰ Based on IMF classification, the level of development of a country can be measured using economic criteria such as per capita income or gross domestic product (GDP) and non-economic criteria such as the Human Development Index (HDI) (IMF, 2012).

(information), are exposed to different information. Ideally, the sender has to decide while sending the signal the method with which it can be communicated, while the receiver also needs to decide on how the signal can be deciphered (Connelly *et al.*, 2011). Signalling theory is also known as information content theory.

Two features render a signal significant. Firstly, it must reduce information asymmetry among the contractual parties. Secondly, the signal must describe the information enough (Kirmani and Rao, 2000). According to Rahman *et al.* (2013), the signal must satisfy the conditions of transparency both to the sender and the receiver, and conditions of credibility as the misrepresented signal can impact negatively on the sender. Additionally, Spence (1973, 1976) claimed that for a signal to be adjudged right, it must exhibit the following three features:

- (a) the motive to convey the signal by the firm;
- (b) the manipulation of the signal is within the control of the firm, and
- (c) the cost of the signal is negatively associated with the signal for high-quality firms in comparison to low-quality firms.

All these three features relate closely to earnings management. On the one hand, managers of firms relay financial information whose earnings might have been managed to users (Rahman *et al.*, 2013; Arya *et al.*, 2003). Therefore, through the informational earnings management, mainly when earnings are managed upward, the confidence of the investors while assessing the operational performance of the firm is boosted. Corroborating this, the findings of Subramanyam (1996) depict a positive association between stock returns and discretionary accruals (DACC) as a proxy for earnings management. This implies that one way of enhancing investors' confidence is through EM, and this will consequently result in increased stock prices. Managers can also be

motivated into practising EM for an increased bonus (Guidry *et al.*, 1999). Consequently, informational earnings management minimises information asymmetry (Bartov and Bodnar, 1996) and capital costs (Francis *et al.*, 2005).

On the other hand, managers often undertake EM through the manipulation of accounting numbers using their discretion to have buoyant profits. This can be done in any of, but not limited to, the following ways: (a) determining the useful life of assets for depreciation, (b) the depreciation method to be adopted, and (c) the percentage of contingency debts. According to Arya *et al.* (2003), the third feature of a signal is that it correlates negatively with cost in high-quality firms compared to low-quality firms. This can serve as an impediment for low-quality firms to use high-quality firms as a benchmark. In other words, managers of high-quality firms will strive to engage informational EM to distinguish themselves from low-quality firms (Morris, 1987). This implication of signalling theory is that it envisages the tendency that earnings management will enhance the quality and content of accounting information.

4.5 Hypothesis Development

Based on the literature reviewed in the preceding chapter, this section discusses the variables used in this study, following the classifications of firm-specific and country-related variables and the development of the set of hypotheses that addresses the research questions.

4.5.1 Firms-Specific Variables

4.5.1.1 Earnings Management and Adoption of IFRS.

One of the justifications for the popularity of the IFRS among countries over their local GAAPs was the assumption that the quality of financial reports prepared from it would be more comparable and reliable. Hence, it is expected that the adoption of IFRS should reduce the extent of

earnings management. Accounting information in developed economies has been observed to be highly influenced by the quality of the accounting standards (Hung and Subramanyam, 2007). However, given the poor enforcement and low risk of litigation in emerging economies, the quality of reported financial statements of firms might be compromised by managers, thereby sending false signals to users. As noted by Leuz (2003), while the motivation of managers towards earnings management can be curbed through accounting standards, the quality of reported financial statements is more dependent on the way the standards are enforced.

Furthermore, Ewert and Wagenhover (2005) argue that comprehensive and stricter accounting rules are a core factor in reduced earnings management and higher quality of reported earnings. Further, Ho *et al.* (2015) affirm the ability of the adoption of IFRS to reduce discretionary accruals through the egotistical interpretation of complex accounting rules, thereby making firms apply the standards in their 'spirit'.

Evidence from the literature regarding developed economies revealed that IFRS enhanced the quality of earnings through reduced accrual earnings management in Germany more than Germany's GAAP (Hung and Subramanyam, 2007). This was consistent with Barth *et al.* (2008), where the 21 countries studied exhibited improved accounting quality due to the application of IAS. The authors found that the companies engage in less income smoothing. They also observed a strong correlation between accounting information and share prices and the return of the companies were observed.

Furthermore, having studied 32 countries, Cai *et al.* (2008) found a consistent decline in the extent of earnings management among countries that adopted IFRS. They further emphasised that countries having stricter enforcement system are equally identified with lower earnings management. Houqe *et al.* (2012), having investigated 46

countries, also established a positive relationship between IFRS adoption and the quality of reported earnings, especially when investors' protection in the country is strong. In line with this, Lemma *et al.* (2013) found that adopting IFRS could be instrumental to a reduction in agency costs and higher transparency. Their findings from the 44 countries studied revealed a negative relationship between IFRS adoption and discretionary accruals.

Conversely, Tendeloo and Vandstraelen (2005), having examined public listed companies in Germany, argued that adoption of IFRS does not significantly influence the degree of earnings management more than the German local standard does. This was corroborated by the findings of Paananen (2008) regarding firms in Sweden.

Furthermore, Jeanjean and Stolowy (2008) emphasise the importance of management incentives and institutional factors in the preparation of financial reporting and that they have a stronger influence on reporting quality than the accounting standards. They also argue that achievement of a uniform reporting system among countries should be premised on harmonised competitive rules and legal enforcement systems, market access requirements and effectiveness of legal systems and not the uniform standard *per se*. Having analysed the effect of the mandatory IFRS adoption on earnings management in France, Australia and the United Kingdom, they found no significant reduction in the extent of earnings management on the adoption of the IFRS, particularly in Australia and United Kingdom. However, France had a different result of increased earnings management.

Considering evidence from emerging economies, Sang-Kyu, and Jing (2012) studied the effect of the relationship between IFRS adoption and earnings management by comparing the direction and magnitude of earnings management using pre- and post-IFRS criteria of Chinese firms. They found higher total and discretionary accruals after the

adoption of IFRS than when the companies reported on Chinese GAAP. This indicates that after the adoption of IFRS, higher earnings management was observed among Chinese firms. Likewise, Rudra and Bhattacharjee (2012) also found higher level earnings management identified with IFRS-compliant firms in India. This motivates this research to review the relevance of IFRS adoption to emerging economies as far as minimising earnings management is concerned.

In a recent study, Ho *et al.* (2015) investigate the effect of IFRS adoption on both accrual-based and real earnings management¹¹ among Chinese firms. They found improved earnings quality and reduced earnings management. This indicates that the adoption of IFRS by Chinese firms will reduce the extent of accrual-based earnings management.

IFRS is used twice as both test variable and control variable in this study. Consistent with earlier studies, it assumes a binary variable of 1 where the company prepares financial statements according to *IFRS* (i.e. post-IFRS period being 2006-2015) and 0 for the pre-adoption period being 1995- 2004, each of which is a 10 year period. Also, to investigate the impact of IFRS adoption on earnings management activities, this thesis uses a dummy variable as the IFRS adoption position of the countries¹². Further country-level variables are discussed below:

On this premise, the following hypothesis is formulated:

¹¹ As IFRS adoption is more directly related to discretionary accrual than real earnings management, this research focuses on discretionary accrual using the modified Jones Model. It however, reviews real earnings management as a subset of earnings management. Moreover, prior studies established that adoption of IFRS does not significantly affect the level of real earnings management (Doukakis, 2014; Capkun *et al.*, 2016; and Sun, 2011)

¹² This is consistent with Ho *et al.* (2015), Lemma *et al.* (2013), Rudra and Bhattacharjee (2012) and Sang-Kyu and Jing (2012).

H1: There is a negative relationship between IFRS adoption and earnings management practices¹³.

3.4.1.2 Control variables.

Gleaning from positive accounting theory and the literature, the company's size, debt profile and equity are key control variables that have been established to have great bearing on earnings management.

Size

Different measures of firm size are documented in the earnings management literature. However, there is no universal measure of firm size (Shalit and Sankar, 1977). The measure adopted is often driven by the objective the researcher intends to achieve. The popular bases of measurement comprise total assets, market capitalisation and the volume of sales (Elkalla, 2017; Al-Khazali and Zoubi, 2005).

Further, Dang *et al.* (2017) maintained that choosing a measure of size depends on the specific area of firm size and the financial implications that this might provoke. They favour measuring firm size by market capitalisation over other measures because it is market-based and future inclined. However, the measure is based only on ownership of equity. Conversely, Omid *et al.* (2012) and Rezaei and Roshani (2012) measured firm size as the natural logarithm of market capitalisation.

Nonetheless, the sales volume measure is highly dependent on the market for the firm's products and has been criticised¹⁴ for not being a forward-looking measure. The total assets basis considers aggregate assets of the firm but has been criticised for the fact that the total assets of firms are usually reported at historical cost and, where they are revalued, it might lead to inconsistency in the valuation of firms' size.

¹³ All hypotheses are stated in their alternative form.

¹⁴ See Chen and Liu (2010) and Lemma *et al.* (2013).

Following Sellami and Fakhfakh (2014) and Watts and Zimmerman (1987), this thesis measures the size of firms as the natural logarithm of the total assets. This is justified on the grounds of achieving consistency, as most variables are lagged by total assets and the fact that the measure considers the total asset of the company.

The literature establishes the correlation between firm size and the degree of earnings management exercised by managers. However, no consensus was reached on the direction of the association. On the one hand, a school of thought argues that bigger firms have better internal control systems, better audit quality, higher reputation cost and, ultimately, engage in fewer earnings management. The findings of Bedard *et al.* (2004) and McMullen (1996) revealed that a positive relationship exists between company size and the reliability of financial statements. Also, Bozec (2008) argues that the fact that published financial statements of larger firms are doggedly monitored by analysts might motivate them to produce high-quality financial reports (reduced earnings management). The results of Houqe *et al.* (2012) and Klein (2002) also corroborated that the size of firms is negatively correlated with their discretionary accrual.

On the other hand, another school of thought argues that the bigger the firm, the higher its tendency towards increased earnings management to meet earnings thresholds and analysts' expectations (DeFond and Jambalvo, 1994). According to Watts and Zimmerman (1990), large firms often embark on downward earnings management in order to conceal their profitability in a bid to minimise government control over them. Also, according to Watts and Zimmerman (1987), bigger firms may incur greater political costs than smaller companies because they are more open to the public and investors' scrutiny.

Apart from being used as a proxy for political costs¹⁵, company size has also been used as a measure of internal control (DeFond and Jambalvo, 1994). Consistent with political cost theory, larger firms are inclined to manage their earnings downward to avoid undue pressure from the government. This is because constantly increasing profits may attract excessive government control and the imposition of more tax levies on reporting companies (Watts and Zimmerman, 1990).

Othman and Zeghal (2006) also affirm that firm size is significantly and positively correlated with reduced earnings management among French firms. Also, Dumontier and Raffournier (1998) showed that Swiss firms were motivated to adopt the IAS/IFRS voluntarily due to political costs and pressures emanating from foreign capital markets. Lobo and Zhou (2006) also add that larger firms, because of operational complexities which make detection of overstatement difficult, might be inclined to manage their earnings. In line with this, additional political costs can be avoided through the application of IFRS, thus reduced political costs may encourage more large firms to adopt IFRS. Hence, this thesis tests the significance of firm size to earnings management before and after the adoption of IFRS.

Furthermore, this research evaluates the differential impact of the adoption of IFRS on firms' size and comparatively assesses the experience in developed and emerging economies. This is done on the assumption that there is a negative relationship between a firm's size and the degree of earnings management after IFRS adoption. Following the models used by previous studies (Zeghal *et al.*, 2011; Othman and Zeghal, 2006; Bozec, 2008 and Street and Gray, 2002), the firm size will be measured against total assets for relevant years of study.

¹⁵ See Othman and Zeghal (2006), Zeghal *et al.*, (2011) and Kolsi and Zehri (2014).

According to Kim, Liu, and Rhee (2003), two conflicting expectations have also been identified from the relationship that subsists between earnings management and the firm's size. Based on the two conflicting arguments, the expectation of the firm's size in relation to earnings management, especially on adoption of IFRS is unclear.

Debt Issue (DISSUE)

Firms' debts have a multi-dimensional influence on earnings management. Therefore, the findings of the effect of debt on earnings management, as documented in the literature have been ambiguous. On the one hand, based on the debt hypothesis, highly geared firms have a high tendency of managing their earnings upward in order to avoid breaching their debt contracts (DeFond and Jiambalvo, 1994; Watt and Zimmerman, 1990). The study conducted by Othman and Zeghal (2006) on French firms established a positive relationship between earnings management and contractual debt costs. They further argue that while avoiding violating debt covenants, banks loans played a significant role in upward earnings management in France. They also emphasised that France seems to give more credence to the debt hypothesis. According to them, the contractual cost of debts is directly associated with the motivations for earnings management among French firms.

Conversely, managers' tendency to manage earnings will be constrained due to creditors' supervision to ensure improved governance (Bozec, 2008). Consequently, in this study, it is expected that the level of earnings management on the adoption of the IFRS is directly associated with the degree of companies' debt.

Leverage (LEV)

While describing the capital structure of a firm, Subramanyam and Wild (2009) evaluate it around equity and debt financing of a firm which

might vary in risk and contracting terms. Hence, the process of funding a firm through debt is known as financial leverage (Groppelli and Nikbakht, 2006). A firm that finances an aspect of its business by contracting long-term debt is therefore known as a levered firm.

The literature established different measures of firm's financial leverage. These include the debt-to-equity ratio, the total debt ratio and the equity multiplier ratio (Ross *et al.*, 2013). The debt-to-equity ratio measures the extent to which a firm relies on debt for its equity. It is measured as total debt divided by total equity (Liu *et al.*, 2011).

On the other hand, the total debt ratio measures the proportion of a firm's assets that are financed by debt. The equity multiplier ratio measures the proportion of the firm's total assets to its total equity. It is calculated by dividing total assets by total equity. The most popular measure of leverage in earnings management literature¹⁶ is the proportion of long-term liabilities to total assets (DeFond and Jambalvo, 1994; Othman and Zeghal, 2006; Sellami and Fakhfakh, 2014; Kao 2014). Hence, due to the multi-country nature of this study and its wide use in the literature, we adopt the latter measure.

Scholars emphasise the positive relationship between leverage ratio and earnings management (Houqe *et al.*, 2012; Klein, 2002). While another school of thought emphasises that managers of most highly geared firms engage in earnings management to minimise default risks and escape violating debt covenants (Sellami and Fakhfakh, 2014; Kim *et al.*, 2012; Roychowdhury, 2006), others argue that the higher the leverage ratio, the more the operational performance of a company is closely monitored by its creditors. Managers might want to be conservative in this regard (Kao, 2014; Jiang and Yeh, 2007). By our

¹⁶ See Defond and Jambalvo (1994), Sweeney (1994), Sun and Rath (2009), Kim *et al.* (2010), Lee *et al.* (2012), Zamri *et al.* (2013), Zhu *et al.* (2015), Jha (2013), and Kuo *et al.* (2014) and Arsov and Naumoski (2016).

expectation, the coefficient from this ratio should positively correlate with earnings management.

The Big Four

The Big Four firms play a major role in the implementation of IFRS in many countries of the world (Albu, 2011). In line with this, disclosure requirements, measurement and presentation of financial statements in compliance with IFRS are expected to influence the financial reports of firms audited by one of the Big Fours. Dwelling on prior studies, firms may still smooth their earnings after the adoption of the IFRS, but if audited by any of the Big Four firms, earnings management can be constrained (Zeghal *et al.*, 2011). Van Tendeloo and Vanstraelen (2005) argue that, generally, German firms that adopted IFRS still had increased earnings management, but those audited by the Big Four had a drastic reduction in earnings management. Therefore, this study uses the engagement of any of the Big Four audit firms as a measure of audit quality. It further tests how the interaction of the engagement of any of the Big Fours with the adoption of IFRS influences the level of earnings management of reporting firms.

Prior researchers have established the relevance of audit quality to the reliability of financial reports through reduced earnings management (Yasar, 2013). Higher audit quality and good enforcement of financial reporting standards are default expectations of users of financial statements from the Big Four in contrast to non-Big-Four audit firms (Zeghal *et al.*, 2011; Van Tendeloo and Vanstraelen, 2005; DeFond and Jambalvo, 1994). Therefore, the variable Big Four has been established in the literature to have a direct negative relationship with earnings management. In other words, companies audited by one of the Big Four have a lower inclination to practising earnings management (Zeghal *et al.*, 2011; Othman and Zeghal, 2006). This implies that high audit

quality as expected from the Big Four firms will provoke improved reported earnings quality.

In a study on application of the international accounting standards (IAS), Al-Basteki (1995) studied 26 Bahrain listed firms and their financial reporting and disclosure based on IAS. The variables of analysis include the reputation of the external auditor, firm size, industry sector, the extent of foreign operations and extent of leverage. The results reveal that the type and reputation of the external auditor, especially the Big Four have a strong influence on the decision to adopt IFRS. In the same vein, the result of the study conducted by Joshi and Ramadhan (2002) on accounting practices and the degree of IFRS adoption for 36 Bahrain SMEs reveals that 86% Big Four audited companies are IFRS compliant.

However, the auditors' incentive to provide quality audit might be limited due to the economic operating atmosphere of the company they audit. According to Yasar (2013), the motivations of auditors' incentives to provide high-quality audit is relatively narrow in emerging economies. This implies that the tendency to provide high audit quality through the engagement of any of the Big Four is related to the economic status of the country in which the firm is domiciled. Therefore, making a general conclusion that engagement of any of the Big Four for audit quality to discourage earnings management needs further examination.

Furthermore, some research findings reveal that engagement or non-engagement of any of the Big Four make no difference to the incidence of earnings management¹⁷. On the contrary, research conducted among the developed countries, including the USA, reveals the relevance of the audit quality of the Big Four to constraining earnings management

¹⁷ See Jeong (1999), Park *et al.* (1999), Yasar (2013), Tsipouridou and Spathis (2012), Jeong and Rho (2004).

(Teoh and Wong, 1993; Becker *et al.*, 1998). The findings from these studies show that the size of the audit firm, used as a proxy for audit quality, have no impact on discretionary accruals. This means that there is no difference in audit quality between Big Four and non-Big-Four auditors for restriction of earnings management in Turkey during the sample period. This result is very much in line with evidence from Korea¹⁸ and Greece¹⁹, but different from studies conducted on firms in the USA and other developed countries²⁰.

Based on this premise, this study contributes to the literature by evaluating the impact of the engagement of any of the Big Four firms on earnings management before and after the adoption of the IFRS. In other words, this study evaluates the correlation between being audited by the Big Four and EM on the adoption of the IFRS. This is examined in relation to the economic status of the country the audited company operates from.

It is therefore hypothesised that:

H2: There is a negative relationship between earnings management and audit quality on the adoption of IFRS.

Free Cashflow

There are three dimensions of free cash flow as documented by Ross *et al.* (2013): cash derived from day to day operational activities of the business (operating cash flows), cash spent on acquisition of fixed assets less proceeds from disposal of any its portion (capital spending)

¹⁸ Jeong (1999); Park *et al.* (1999); Jeong and Rho (2004)

¹⁹ Tsipouridou and Spathis (2012)

²⁰ See Becker *et al.* (1998), Teoh and Wong (1993).

and change in the working capital over the reporting period. This thesis, due to lack of adequate data, adopts the operation cash flow dimension.

However, accrual accounting has been argued to be flexible, thereby making the accrual element of corporate earnings less realistic in comparison to the cash flow component of earnings (Doukakis, 2014, Larcker *et al.*, 2007). Francis and Wang (2008) document an inverse relationship between accruals and cash flow from the operation. Also, Lee (2011) emphasise the direct impact of misstatement of earnings on the firm's cash flow from operation. Therefore, managers often use their discretion in managing cash flow from the operation, just as they manage earnings.

Consistent with Chen *et al.* (2016), low propensity to manage earnings is common with companies having significant operational cash flows and vice-versa. However, little has been done on the extent to which EM influences reported cash flow from the operation. Also, there is a gap in the literature on the sensitivity of this association to IFRS adoption, especially in emerging economies. On this premise, the inclusion of this control variable is to evaluate the effect of earnings management on cash flow from the operation and observe the sensitivity of this relationship to IFRS adoption.

In a contribution to literature, this study builds on the theoretical backgrounds in earlier studies about cash flow from operation and earnings management more importantly among emerging economies. As a performance measure of firms, it is lagged with the value of total assets at the beginning of the period as used in Zeghal *et al.* (2012) and Sun *et al.* (2011).

Conflicts of interest often arise on cash from operation (Free Cash flow²¹) that has not been distributed as dividends after financing all feasible and profitable projects (Jensen, 1986 and Nekhili *et al.*, 2016). Such cash is often left at the discretion of the managers who usually use this, in most cases, not in the interest of the company but their own. Agency conflicts often arise in the use of free cash flow, especially when investment opportunities arise. For instance, in the event of projects ran at negative net present value, managers of firms with low growth opportunities but high free cash flows might indulge in upward earnings management through discretionary accruals aimed at increasing net income. According to the study of Chung *et al.* (2005) on US firms, most expenditures that managers of low growth but high free cash flow firms make are not towards maximising shareholder wealth. Hence, some risk-averse managers often side-line profitable projects in which rational shareholders would have undertaken to invest. Also, in avoidance of perfecting merger and acquisition bids, managers might increase the reported earnings through the exercise of accounting judgements.

According to prior research, agency costs are not significant to companies with good growth opportunities (Alonso *et al.*, 2005; Lasfer, 2006; Gregory and Wang, 2013). On the contrary, where the growth opportunity is lacking, there is a tendency of overinvestment surfacing, and this is not in favour of the shareholders, especially the minority shareholders. This is because of managers' incentive to ensure that the company's growth through its size is sustained, to ensure they have improved compensation (Jensen and Murphy, 1990) and more exercise of their discretion (Stulz, 1990).

²¹ Free cash flow can be defined as net income plus depreciation and amortization minus capital expenditures (Mills *et al.*, 2002 and Elkalla, 2017).

An FCF can inadvertently be used in the repurchase of company's shares and related parties' transactions with managers, major shareholders and directors may crop up. In these cases, minority shareholders are exploited (Nekhili and Cherif, 2011). This will negatively affect the company's financial status, cause reduced share prices and eventually lead to the removal of managers (Opler *et al.*, 1999; Richardson, 2006). To avert this, managers often delve into earnings management to conceal their selfish use of funds (Leuz *et al.*, 2003). The results of Jaggi and Gul (2006) reveal a positive correlation between FCF and earnings management. They emphasise that managers, to secure their jobs and presentation of their firms as performing firms, do manage earnings upward. In confirmation of this, Chung *et al.* (2005), posit that companies with high FCF levels often cover their negative NPV projects using discretionary accruals.

More explicitly, Rusmin *et al.* (2014) posit that the association between FCF and managers' discretion for upward earnings management is dependent on the peculiar features of the institutional environment and is therefore not systematic. The authors argued for a positive correlation between FCF and income-increasing accounting choices among Malaysian firms. On the other hand, Chung *et al.* (2005) argued that an FCF situation might motivate managers into downward earnings management. In their findings, companies with high FCF but low growth opportunities indulge in discretionary accruals to reduce their reported earnings. In their opinion, companies having high FCF and poor growth opportunities will be challenged with low profitability in the long run. Managers often apply negative accruals to cover up imminent poor performance resulting from new investments. This is achieved by reducing the current year's earnings and smoothing earnings on the emergence of the adverse effect of the investments.

In the context of emerging economies, Bukit and Iskandar (2009) studied 155 Malaysian listed companies and also revealed that EM is

more popular among companies with a high level of FCF. They argued that managers of high FCF discretionarily hide their failure to invest in a good project that can maximise shareholders' wealth by reporting higher net income. The authors found a positive association between FCF and earnings management. Evidence from India also revealed that FCF positively correlates with accrual-based earnings management (Rudra and Bhattacharjee, 2012). Also, in Iran, Chalak and Mohammadnezhad (2012) found a positive and significant relationship between FCF and discretionary accruals. In the more recent research of Alzoubi (2016), he found that accrual-based earnings management and FCF among firms in Jordan are positively correlated. Hence, increased FCF may trigger managers' opportunity to invest in projects that are not worthwhile, and they may want to conceal the poor results through earnings management.

Growth

The literature identifies different ways through which firms' growth opportunities can be measured. Adam and Goyal (2000) identify three measures of growth opportunities: the market-to-book ratio of assets, the earnings-price ratio and the market-to-book ratio of equity.

The use of market-to-book ratio is justified by the fact that firms that have good growth opportunities get lower value in return for the assets employed (ROTA). Hence, the ROTA of a firm has been established to be positively related to the growth opportunities of a firm. According to Collins and Kothari (1989), the ratio of the market value of equity to the book value of equity measures the level at which a firm's return on total assets, and anticipated future investment, is above the return on equity required. The third proxy is the earnings-price ratio or the inverse price-earnings ratio. As submitted by Chung *et al.* (2005), increased earnings-price ratio implies a higher percentage of the value of the firm's equity going for its total assets regarding opportunities for

growth. The three proxies for growth opportunities have been adjudged suitable (Elkalla, 2017). Although the most popular measure in accounting literature is the market value of equity to the book value of equity as used in Cohen *et al.* (2008), Gunther, (2011), Ho *et al.* (2015) and Park and Shin (2004), this thesis adopts the more recent measure of growth opportunities. According to the literature²², the growth opportunity of a firm is measured as an annual percentage change in sales.

The literature establishes the essential nature of growth opportunity and its influence on the estimation of the market value of the equity of firms (Pindyck, 1988). Managers can exercise their discretion to influence growth opportunity while meeting expenditures such as advertising, new product or brand name and replacement or maintenance of existing assets (Alnajjar and Riahi-Belkaoui, 2001). Growing companies often engage in upward EM to have improved share prices good enough to attract more investors. The purpose of this is to meet their capital needs. Growth in sales and gross PPE have been documented in the literature to influence annual discretionary accruals where a non-linear association exists between the non-discretionary accruals and determinants (Francis and Wang, 2008; Houqe, 2012). The extent of earnings management has also been established to be influenced by the growth and profitability of a firm (Carey and Simnett, 2006). Therefore, the econometric model used in this research incorporates *GROWTH* and *ROTA*. *GROWTH* measure was used in Ipino Parbonetti (2011), Chen *et al.* (2010), Summers and Sweeney (1998).

Increased growth opportunity is expected to influence the profitability of firms positively. However, the increased political risk that this will

²² Capkun *et al.* (2016), Doukakis (2014) and Sellami and Fakhfakh (2014).

attract might motivate managers to delve into earnings management. Also, based on political cost hypothesis, firms may resort to earnings management by reporting reduced earnings to minimise government impositions in the form of increased tax incidence (Monti-Belkaoui *et al.*, 1999; Watts and Zimmerman, 1987). Hence, downward earnings management can be prevalent among firms with higher growth potentials than those with low growth potentials. Sun and Rath (2009), while exploring the association between earnings management and growth prospects of firms, argued that managers might be motivated into earnings management to achieve higher growth, having known the implication of its uncertainty on earnings volatility. Apart from this, managers of growth firms may present the firms as having a bright future so that they can stand a better chance of obtaining external funds (Lemma *et al.*, 2013). However, growing firms, in pursuit of enhanced earnings quality, might want to desist from earnings management to position the firm better for financing at a reduced cost (Gaio, 2010). On this premise, growth opportunity tends to reduce earnings management. Furthermore, engaging in earnings management might be made difficult due to the close observation of external users of the financial statement.

In the context of developed economies, Lemma *et al.* (2013) studied 44 countries and posited that growing firms are more likely to desist from earnings management to enhance the quality of their reported earnings and attract external capital at a reduced cost of capital. Their findings revealed a negative relationship between firms' growth and discretionary accrual-based earnings management. Kim *et al.* (2010), Lara *et al.* (2012) and Anagnostopoulou and Tsekrekos (2016), also document a negative association between earnings management and firms' growth among US firms. Conversely, Doukakis (2014), based on the study conducted on 22 countries, argued that there is a positive association between firms' growth and earnings management. This builds on and confirms

the findings of Roychowdhury (2006). Consistent with this, Alnajjar and Riahi-Belkaoui (2001), in line with the political cost hypothesis, found that managers of growing companies often reduce their reported earnings through the discretionary use of accounting choices. While establishing the effect of discretionary accrual on firms' growth among US firms, Robin and Wu (2012) found no significant difference between high growth firms and low growth firms as far as their engagement in discretionary accrual towards earnings management is concerned.

As evidence from emerging economies, Ho *et al.* (2015), based on a study conducted on Chinese firms, argued that firms with high growth have a lower extent of earnings management. On the other hand, Kuo *et al.* (2014) find a positive association between firms' growth and earnings management among Chinese firms. The results of Chen and Liu (2010), though on Taiwanese firms, revealed that high growth firms are more inclined to engage in earnings management than low growth firms.

Further, Hessayri and Saihi (2015), in a study conducted on Morocco, South Africa, the Philippines and UAE, found that high growth firms are more likely to engage in upward earnings management to avoid not meeting their expected earnings. They document a positive interaction between discretionary accrual earnings management and growth opportunities. The recent study of Alzoubi (2016) also confirmed the positive relationship between firms' growth and the exercise of discretionary accruals for earnings management in Jordan. Hence, based on this premise it is expected that high growth firms are more inclined to engage in upward earnings management (Kim *et al.*, 2005).

Profitability (ROTA)

In line with prior studies, return on total assets is a measure of a firm's performance, especially profitability. This is evidenced by Kuto *et al.* (2014), Zhu *et al.* (2015), Ho *et al.* (2015), Swai (2016) and Hessayri and Saihi (2015). Although the literature documents different measures of profitability, including return on equity, the operating income margin and the net profit margin, this thesis adopts the return on total assets based on the following justifications. First, both expenses incurred and incomes generated have a direct linkage with the assets used in generating them. Second, unlike the return on equity, which portrays the level of profitability to the equity capital, ROTA does not vary with the extent of leverage (Growe *et al.*, 2014). Third, ROTA is widely used by researchers as a measure of profitability in the field of earnings management.

A rational investor will only invest in profitable companies with the prospect for growth in benefits above the sum invested and future dividends as well as the security of the principal sum. The choice of dividend policy by managers, therefore, has been established in the literature to impact on reported profits (Gunther, 2011). Also, managers might resort to upward earnings management in order to make the firm look attractive to investors. On the premise of agency theory, conflict often arises between internal shareholders and their external counterparts on how the return on total assets is appropriated. According to La-Porta *et al.* (2000b), external shareholders are more interested in dividends than retained earnings, especially in countries with weak investors' protection.

Profitability is also an operational performance measure of a firm. Return on total assets is calculated by dividing operating profit by the value of total assets at the beginning of the period. Since only profitable companies can pay dividends, there is a direct association between a firm's profitability and dividends payable. The findings of Harris *et al.* (1994) assert that the relationship between earnings and dividends enhance the inclination of firms towards earnings management so that favourable dividend payout ratios can be achieved.

According to Sun and Rath (2009), the fact that less profitable firms are susceptible to financial bottlenecks makes the extent of earnings management seem to be influenced by the profitability of a firm. They argued that there is a direct relationship between the operating performance of firms and the level of earnings management exercised by their managers. However, Kim *et al.* (2015) argued that financially stable firms are often firms with higher profitability and would seldom engage in earnings management. They found a negative association between the extent of earnings management and profitability. Contrarily, the findings of Hessayri and Saihi (2015) revealed that increased profitability might lead to increased earnings management

where management's remuneration is based on the financial performance of the firm.

As evidence from the developed economies, Doukakis (2014), having studied 22 European countries, argued that higher levels of earnings management characterise firms with low profitability. The results of Kim *et al.* (2010) on US firms also confirmed the negative relationship between firms' profitability and the extent of earnings management. This is also consistent with the findings of Chen (2009) that the association between firms' return on total asset (ROTA) employed and the level of earnings management among US firms is negative. However, Sun and Rath (2009), based on a study conducted on Australia firms, found that profitability is a critical factor in the determination of accruals-based earnings. They argued that the return on total asset (ROTA) is positively associated with the level of earnings management. Further, the findings of Chen *et al.* (2015) that firms with higher profitability are usually less motivated to engage in earnings management aligns with this.

In emerging economies context, Ho *et al.* (2015) and Kuo *et al.* (2014) found that lower levels of earnings management are identifiable with firms with higher profitability in China. Also, the study of Ashari *et al.* (1994) on firms in Singapore revealed that firms having lower profitability and high earnings volatility engage in more income smoothing. Conversely, Zamri *et al.* (2013) found a positive relationship between discretionary accruals and the profitability of Malaysian firms. Ghazali *et al.* (2015), also found that the higher the profitability of a firm, the higher its likelihood of engaging in higher levels of discretionary earnings management.

Further, on emerging economies, Alzoubi (2016) and Abbadi *et al.* (2016) found a negative association between profitability and discretionary accrual inclined earnings management among firms in

Jordan. However, the study conducted on South Africa, Morocco, and the Philippines by Hessayri and Saihi (2015) reveal a positive correlation between earnings management and profitability. The results of the study conducted on Tunisian firms by Hamza and Bannouri (2015) corroborate the positive relationship between profitability and earnings management.

Meeting investors' and analysts' expectations may incite managers into engaging in upward earnings management. Given the poor accounting infrastructure and political instability common among emerging economies, the more profitable firms have a high inclination towards a higher level of earnings management. This study thus intends to establish the statistical implication of the return on total assets employed (ROTA) regarding earnings management on the adoption of IFRS of both developed countries, where investors' protection is prevalent, and emerging economies where investors' protection is perceived to be weak.

4.5.2 Country-Level Variables

Recent studies have empirically established the essence of country-level variables in cross-country studies relating to EM activities among firms of diverse countries. Significant cross-country discrepancies in EM activity were observed (Gaio, 2010; Lemma *et al.*, 2013; Daske *et al.*, 2013). Leaning on prior studies, the apparent differences in EM activities among countries might be traceable to cross-country differences in socio-economic environment, market forces and institutional structures (Leuz *et al.*, 2003; Othman and Zeghal, 2006; Burgstahler *et al.*, 2006; Renders and Vandenbogaerde, 2008; Enomoto *et al.*, 2012). Subsequently, this study synthesises the literature on the nexus between country-level variables such as governance structures and political activities of countries and the earnings management activities of firms domiciled in them.

The literature documents studies that examine the nexus between corporate governance, law and managerial decisions (Lemma *et al.*, 2013; Gillan, 2006; Pistor *et al.*, 2000). The basis of the argument is that legal frameworks have significantly influenced the way economic agents behave in various ways. Firstly, legal pronouncements issued by the property rights protection institutions significantly influence the nature of agency conflicts and the transaction costs that managers would face. Where investors' rights protection is strong, and the quality of law enforcement is good, agency conflict and transaction costs are bound to reduce.

Secondly, given strong investor protection, sound financial and disclosure laws and active law enforcement, the confidence of users of financial statements about the markets and their developments are usually boosted (La-Porta *et al.*, 1997; Shleifer and Vishny, 1997; Levine, 1999; Pistor *et al.*, 2000; Djankov *et al.*, 2008).

The resultant effect of this is that the level of information asymmetry between the users of financial statements (internal or external) would be affected. Further, market participants of countries having robust legal and regulatory enforcement systems are usually identified with the reduced level of information asymmetry (Healy and Palepu, 2001; Gleaser *et al.*, 2001; Eleswarapu and Venkataraman, 2006; La Porta *et al.*, 2006; Reverte, 2008).

4.5.2.1 Governance Indicator

Gleaning from prior studies, this research agitates that the quality of reported earnings might not singularly depend on the accounting standards in force, but more on the regulatory and enforcement framework as well as the setting of application (Ball, 2016). Hence, consistent with Kirch *et al.* (2009), Lemma *et al.* (2013), some of the country-related variables used in this study include political stability,

voice and accountability, control of corruption, government effectiveness, the rule of law, and regulatory quality.

On this note, it is logical to deduce that countries with a sound rule of law and effective regulatory systems are prone to be more transparent and equitable in the application of the law. Also, they are characterised by enforcement penalties against violation of the set rules. Hence, the effectiveness of the legal and regulatory infrastructure of a country has many consequences on the financial reporting system of the country and would ultimately influence firms' incentives to engage in earnings management. Hence, this study hypothesises that managers of firms in countries that have effective governance and regulatory frameworks have a lower tendency to manage earnings (Leuz *et al.*, 2003; Lemma *et al.*, 2013; DeFond, 2010).

One of the country inclined variables is corruption. Often described as the abuse of public office for private benefit, most economists perceive it as the single most significant obstacle to economic and social development (Lemma *et al.*, 2013). Apart from being a threat to the social and economic atmosphere of a country, corruption hampers the rule of law and weakens the institutional structure of society (Mauro, 1995). Besides, it is associated with factors such as the absence of political accountability and proper protection of property rights, which are all impediments to economic growth (Tanzi, 1998; Ng, 2006; Rose-Ackerman, 2006; Aidt, 2009). Firms in countries having a high level of corruption are also characterised by reduced efficient financial markets, increased operating costs and poor corporate governance (Kimuyu, 2007; Ng, 2006; Stulz, 2005).

Furthermore, corruption generates agency conflicts and information asymmetry problems due to weak market institutions. Hence, this study speculates that firms domiciled in countries having higher levels of corruption will likely engage more in earnings management activities.

In addition to corruption, investors are more confident about their investments when a country is politically stable, and there is the prevalence of the rule of law (Eleswarapu and Venkataraman, 2006).

Similarly, government effectiveness can also affect the level of information asymmetry in a country. It is, therefore, expected that political stability and government effectiveness of a country should be positively related to the possibility that a firm manages its earnings. Globerman and Shapiro (2002) reported a high correlation of these indices with one another. It was also observed in this study that using all the indices causes multicollinearity issues. Hence, following Lemma *et al.* (2013) and Kirch *et al.* (2009), this study avoided the likelihood of multicollinearity problems among the aforementioned additional country related variables through principal component analysis (PCA). PCA enables the derivation of an aggregate score for all the six indices² without any multicollinearity issue. The aggregate score derived is referred to in this thesis as a governance index or indicator²³ (GOVind).

The emergent factors after using the PCA are dependent on the Eigenvalues. The factors that would subsequently be retained must have eigenvalues that are greater than one. In order to enhance interpretation of factors obtained, there is a need for the rotation of the factors either in orthogonal (where the derivation of uncorrelated factors is the objective) or oblique manner. The former is employed in this thesis because the objective is to derive uncorrelated factors. This

²³ Data relating to Governance indicators were collected from <http://info.worldbank.org/governance/wgi/#home>. It includes the six dimensions of governance of 200 countries for the period of 1996-2016. The six dimensions are Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. Later in this study, the indices are aggregated using the PCA (Principal Component Analysis) and used as a single country-specific variable tagged GOVind (Governance Index).

method is also known as the Varimax method. It is very popular in practice and offers a less complex solution than other methods. Alternatively, the country level indices can be incorporated in the model one by one. Consistent with Elkalla (2017), this thesis also controls for potential multicollinearity issues that might result from the country level variables by using a separate empirical model.

This thesis argues that adoption of the IFRS in an economic setting of good governance; provides a thriving platform for the efficacy of the standards in curbing earnings management. Though no evidence exists in the literature regarding this, it is worth finding out how the interaction of IFRS and GOVind variables might impact on the extent of earnings management practised by firms in the countries of study.

It is therefore formulated that:

The following hypothesis is, therefore formulated:

H3: There is a negative relationship between the level of earnings management and the adoption of IFRS by countries with good governance score.

4.5.2.2 Economic Status²⁴ (ECOSTAT)

One of the arguments of this research is that, although evidence exists in the literature about the positive impact adoption of IFRS has made on the quality of published financial statements, countries are never at the same level of economic development neither do their accounting systems align. On this premise, the extent to which the IFRS has impacted financial statements of countries is likely to differ. Hence, as part of the objectives, this study critically assesses the contribution

²⁴ See note 7

made by economic status to the efficacy of the IFRS in curbing earnings management.

In order to determine whether IFRS is a one size fits all standard, there it is vital to evaluate the influence of IFRS adoption on the level of earnings management of both developed and emerging economies. The interaction of the IFRS adoption and ECOSTAT with the EM measure affords us to get the sensitivity of IFRS adoption to the economic status of country in the course of promoting the quality of financial reporting.

Based on weak enforcement system and poor accounting infrastructure commonly identified the firms in emerging economies, it is expected that a higher level of earnings management is found in emerging economies. The following hypothesis is, therefore formulated:

H4: There is a negative relationship between earnings management and adoption of IFRS by countries of higher economic status.

4.5.2.3 GDP Growth Rate, IFRS Adoption and Earnings Management

Due to how the international accounting standards originated (from the developed economies, more precisely from Europe), this thesis among other things tests the diversity in the degree of earnings management as related to the level of economic development of countries before and after the adoption of the IFRS. The basis for this is that composition and the organisational structure of the IASB have been argued to have placed developed countries in a dominant position compared to emerging economies. Furthermore, the topics covered in the international standards have been criticised for being a reflection of the operational circumstances of developed economies (Zehri and Abdelbaki, 2013).

According to Arpen and Radebaugh (1985), one of the principal variables to consider while examining accounting development is economic development. However, the relationship between IFRS

adoption and economic growth has been contentious. For instance, Woolley (1998) found that no significant variance is traceable to economic growth on adoption of IFRS, whereas Zeghal and Mhedhbi (2006) found the IFRS adoption suits developed countries having high economic growth.

In order to gain acceptance among the countries of the world, some of these standards are revised to suit the financial reporting needs of countries in order to accommodate them among the subscribing nations. The alternative ways of treating similar transactions that came up due to this have been argued to encourage earnings management (Capkun *et al.*, 2012).

According to Filip and Raffournier (2014), changes in the economic circumstances of firms might propel them into managing their earnings. Further, Chen *et al.* (2015) argued that earnings management among firms might be the resultant effect of the fluctuation in the economic conditions of the country in which the company is domiciled. During periods of increased economic growth, firms are expected to have an increased level of operation and vice versa (Houqe and Monem, 2013). In other words, increased economic growth should impact positively on turnover. Hence, it will reduce the tendency of managers to engage in earnings management.

Contrarily, firms operating in an economically doomed country are likely to engage in higher accrual-based earnings management to compensate for their losses. In their investigation of the relationship between earnings management and discretionary accruals among US companies, Cohen *et al.* (2008) found a negative relationship between earnings management of firms and economic growth of the country. They argued that adverse economic conditions trigger a higher level of accrual-based earnings management. Multinational companies are not an exception to this finding. They would not like to appear as a failed

entity among other companies. Consistent with this, Gopalan and Jayaraman (2012) found that the GDP growth rate of 22 countries studied correlated negatively with the level of earnings management practised among the countries.

Nevertheless, analysts, investors and other financial statement users would usually place reliance on performing firms than other firms, especially during the period of economic growth. Hence, the pressure to meet analysts' and investors' expectations may lead to increased earnings management, especially among firms in emerging economies characterised by political instability. Such firms often resort to using accounting discretion to manage their earnings and maintain a consistent increase in reported earnings. Based on this, higher economic growth might lead to a higher level of accrual-based earnings management.

4.5.2.4 Human Development, IFRS Adoption and Earnings Management and

The Human Development Indicator

Two Economists developed the Human Development Index (HDI); Mahbub ul Haq and Amartya Sen. However, it was made famous by the United Nations on the platform of the United Nations Development Programme. The compound measure was devised to rank and measure the level of countries' social and economic development according to their national income per capita, the average years of schooling, expected years of schooling and life expectancy. Thus, the level of development of a country is directly related to how high its HDI is. This measure can also be used for tracking changes in levels of development among countries. It facilitates ease of comparison of the levels of development between countries.

Since this is a cross-country study, this research considers the economic stages of development of the sampled countries in the empirical model. This is achieved by incorporating the Human Development Indicator or Index (HDI), which has been described as a good measure of economic development among countries (IMF, 2012). The purpose of incorporating HDI, among others is that the index incorporates the level of education of the relevant country. Accountancy, as a technical profession demands a level of literacy above the average. Also, the level of accounting education is positively proportional to the degree of understanding, interpretation and operationalisation of accounting standards by accountants. Hence, human development factor needs are included in this research. The Index, as published by the UNDP differs from country to country.

Human development is enhanced when accounting information is reliably used as a basis for monitoring and exercising economic and human rights (Kaufman *et al.*, 2007; Leuz *et al.*, 2003). According to Riahi-Belkaoui (2000), increased human development and economic freedom reduce the tendency of managers towards earnings management because the activities of their firms are likely going to be monitored by analysts, investors and other users of financial statements. This is done on the justification of the exercise their economic and human rights. By using two competing hypotheses, the "diversion" hypothesis and the "penalty" hypothesis, Leuz *et al.* (2003) test the association between human development and economic freedom; also between human development and earnings management. The diversion hypothesis expects that managers will exercise lower earnings management at increased economic freedom and human development levels, to conceal their losses from the public when economic circumstances are unfavourable. This study builds on the competing arguments of Leuz *et al.* (2003) and Riahi-Belkaoui, (2004) in the context of IFRS adoption.

The penalty hypothesis postulates that managers will engage in higher levels of earnings management as economic freedom and human development increase; to avoid being castigated for running the business ineffectively. They achieve this through asset diversion to escape the consequences of not making enough profits. Based on the "diversion" hypothesis, earnings management should be less prevalent among countries characterised by a high level of economic freedom that permits monitoring and exercise of economic rights. However, the "penalty" hypothesis posits that earnings management is prevalent among countries with a high level of human development. Managers of such firms must hide diverted assets to avoid being penalised.

The agency conflict resulting from information asymmetries and the managers' privilege in abating shareholders' ability to monitor or discipline them explains the critical basis for increased earnings management. However, this can be ameliorated where there is a clear term of contract giving the shareholders the right to discipline managers. Alternatively, shareholders might decide to vote managers out or withdraw their capital and re-invest it in other firms with less incidence of earnings management.

However, finding a firm with lower earnings management might be as chasing shadows as a firm having lower earnings management at a point in time might not sustain this in the long-run. Nevertheless, the two recourse actions are principally dependent on the degree of human development and economic freedom existing in the country in which the firm is domiciled (Riahi-Belkaoui, 2004).

According to the extant literature, the excellent exercise of economic and human rights has a direct association with the level of human development (Riahi-Belkaoui, 2002). Further investigation is, therefore, required into the relevance of these concepts about earnings management and adoption of IFRS. Based on diversion hypothesis,

managers are more inclined to conceal their firms' weak performance in a country of low human development. Riahi-Belkaoui (2002) find that a negative relationship exists between earnings management and the level of human development among countries studied. This implies that an increased level of earnings management is found among countries with lower human development.

Based on the penalty hypothesis, increased earnings management might be traced to an increased level of human development where managers are penalised for the poor firm performance. Hence countries with high levels of human development are likely to exercise more earnings management. The core message of the "penalty" hypothesis is that the higher the penalties existing in countries with high human development, the higher the tendency that a manager will indulge in earnings management.

The international accounting literature establishes the link between improved human development and financial reporting quality disclosure as a prerequisite for effective dealings in global stock exchanges (Riahi-Belkaoui, 2004). However, no empirical study has been done on how this relationship might be affected by the adoption of the IFRS; neither is there any work on how human development might influence the extent of earnings management among firms. Hence, this research contributes to the literature in this regards by including human development index as one of the variables to empirically establish the phenomenon above. Also, this research emphasises that the quality of reported earnings by firms can be influenced by the extent of human and economic development of their countries.

Furthermore, the sensitivity of the interaction of IFRS adoption and the human development of adopting countries to the extent of earnings management of their firms is examined. Therefore, evaluating the

bearing of the association between a country's choice to adopt the IFRS, the level of their human development and the extent of earnings management among their firms is pertinent. The following hypothesis is, therefore, formulated:

H5: There is a negative relationship between earnings management and human development in countries that adopt IFRS.

4.5.2.5 IFRS Adoption

Worthy of mentioning is another country-level variable: the decision to adopt IFRS. Advocates of IFRS adoption posit that the timely loss recognition and higher transparency promised by IFRS enhance the efficiency of contracting between firms and their managers, and ultimately reduce the agency costs between managers and shareholders (Ball *et al.*, 2003). Nevertheless, the literature empirically established that the gains accruable from IFRS adoption place high reliance on the legal as well as other reporting issues of the reporting firms (Ball, 2006, Daske *et al.*, 2008, Barth *et al.*, 2008; Hail *et al.*, 2010).

4.6. Summary

This chapter explores variables used in studying the nexus between earnings management and the adoption of IFRS. It acknowledges the diversities of countries while adopting the uniform standard (IFRS) based on their levels of economic status, human development and their governance qualities. Unlike the extensively tested firms- specific variables in accounting research, the current popularity of the IFRS demands the inclusion of country inclined variables in its analysis. This chapter examined the variables in this context; hypotheses are also formulated in this regards.

Chapter Five: Research Methodology

5.0 Introduction.

This chapter discusses the method designed in this study to achieve the research objectives. It also explains how the hypotheses are tested for review; this research aim at examining the adequacy of the IFRS in promoting the quality of financial statement through reduced earnings management. This study evaluates the beneficial impact of the adoption of IFRS on firms' ability to raise more capital in the capital market.

Furthermore, the research seeks to investigate the relevance of human development, economic status and governance infrastructure of countries to IFRS adoption and earnings management. Also, this chapter explains the method adopted in assessing how the engagement of the Big Four enhances the effectiveness of IFRS in promoting the quality of financial reporting quality. It also maps out the sample selection and the methodology adopted to substantiate whether adoption of IFRS reduces the extent of earnings management among countries or not.

5.1 Sample and Time Frame

5.1.1 Sample and Sampling Procedures

The population of this study includes all listed companies in the countries used in the study. Based on the nature and the purpose of this study, countries of the world are assumed to be of two extreme classifications: developed economies and emerging economies. The justification of this extreme lies in the fact that IFRS originated from the EU countries that are mostly of developed economic status. Most of the developed countries had been on IAS long enough before IFRS came on board. In addition to this, most countries of emerging economic status whose accounting system rests mostly on their GAAP have now subscribed to IFRS.

This research adopts a purposive sampling method. A total number of 1,028 firms of which 486 relate to the developed economies and 542 emerging economies eventually emerge as the sample for the study. This gives 21,588 total firm-year-observations, of which 10,206 and 11,382 relate to the developed economies and emerging economies respectively. Firms in each country are classified into industries according to the GIC²⁵ standards (see table 5.2 below). Consistent with Zeghal *et al.* (2011), samples are selected from the listed companies in each country based on the following criteria:

- i. Firms must have data for the calculation of accruals in their financial statements.
- ii. Firms must be non-financial firms' due to the peculiarity of their regulation.
- iii. Firms must be in operation between 1995 and 2015.
- iv. Firms selected will be among the 500 top listed firms by market capitalisation for each country. This is to ensure fair comparison among similar firms, both pre-and post-IFRS adoption.
- v. Sample firms must also have a 12-month fiscal year for each year of analysis.

Therefore, following Bukit and Iskandar (2009), Cohen and Zarowin (2010), Shah *et al.* (2010), Zamri *et al.* (2013), and Kuo *et al.* (2014), Doukakis (2014), Ho *et al.* (2015), Hessayri and Saihi (2015), companies that lack the required necessary data for the computation of the dependent and independent variables are excluded.

²⁵ The Global Industry Classification Standard developed by Morgan Stanley Capital International (MSCI) and Standard and Poor's in 1999.

Table 5.1: *Analysis of Sample Selected*

	Developed Economies	Emerging Economies
Publicly listed firms as at June 2016²⁶	<u>1807</u>	<u>1993</u>
Firms not satisfying the selection criteria	1229	1295
Financial Institutions	<u>92</u>	<u>155</u>
Final Sample	<u>486</u>	<u>542</u>

Firms that have adequate data covering the two decades were selected from the countries of study. This affords the regression models to reflect a balanced inclusion of both pre-IFRS periods and the post-IFRS adoption period. By doing this, biases and inconsistencies within the result obtained can be avoided.

The choice of countries sampled for the emerging economies was based on classification by World Economic Situation and Prospect (WESP, 2014), the BRICS developed by O'Neill (2001). The BRICS' classification visualised **Brazil, Russia, India, China and South Africa** as emerging economies perceived as having good economic potential. Malaysia was chosen to replace Russia because Malaysia adopted IFRS early enough and has an excellent financial reporting reform history (Rad and Embong, 2014). Data from firms from these leading emerging

²⁶ Data used in this study was collected cross-sectionally from the Datastream in the month of June, 2016. Firms used in the research are those that satisfy the selection criterion and having adequate data for the period of study.

economies were pooled together in a panel to study how IFRS adoption has influenced the quality of published financial statements.

Concerning the developed economies, data of firms from countries of studies (United Kingdom, Germany, Italy, France and Australia) are also pooled together in a panel to study the effect of IFRS adoption on the quality of reported financial statements. The justification for choosing United Kingdom, Germany, Italy, France and Australia motivated by the work of Jeanjean and Stolowy (2008) who studied United Kingdom, Australia, and France which are all early adopters of the IFRS. The research revealed mixed findings on the effect of IFRS adoption on the quality of financial reporting quality. This might be because the number of years after the year of mandatory adoption is too few.

Hence, this research used a broader time frame as IFRS might take time for its effect to be fully materialised. Germany and Italy were chosen in addition to the UK, France and Australia because they are well researched EU member countries. This is to provide the platform for which the results of this research could be compared. Also, all the countries apart from Australia are members of G7 nations. Industries are classified based on the Global Industry Classification Standard, as used in Chua *et al.* (2012). Industries are partitioned into energy, materials, industrials, consumer discretionary, consumer staples, healthcare, information technology, telecommunication services and utility sectors.

Table 5.2 Industrial representation of Sampled Firms from Each country

	<i>Industry</i>	<i>Energy</i>	<i>Materials</i>	<i>Industrial</i>	<i>Consumer discretionary</i>	<i>Consumer Staples</i>	<i>Healthcare</i>	<i>Telecom.</i>	<i>IT</i>	<i>Utilities</i>	<i>Total</i>
Developed Economies	The UK	10	36	45	56	42	8	2	33	7	239
	Germany	1	8	6	10	11	3	2	5	1	47
	France	9	20	39	33	14	5	1	15	7	143
	Australia	5	5	4	6	1	1	1	1	1	25
	Italy	3	7	4	11	2	1	1	1	2	32
Emerging Economies	China	5	38	28	34	30	17	2	17	3	174
	India	10	20	14	16	11	12	2	1	4	90
	South Africa	1	26	15	15	27	8	2	7	6	107
	Malaysia	4	57	22	24	16	3	3	8	5	142
	Brazil	1	4	9	7	4	1	1	1	1	29
	Total	49	221	186	212	158	59	17	89	37	1028

5.2 The Earnings Management Model Specification

This thesis substantiates the hypotheses above by running an OLS (Ordinary Least Square) pooled regression and the panel regression for robustness check. Based on the nature of the study, I flexibly test the hypotheses to examine the inclusion and non-inclusion of the country inclined variables and its interaction with firm-inclined variables. I also checked the earning smoothing dimension to earnings management for robustness purpose.

Jones Model

Jones model assumes that earnings can be managed through variability in the revenue and the accounting treatment of fixed assets. Normally, accruals should be objectively valued in line with the accounting rules. Although some accruals are determined by the sales revenues (e.g bad debt), depreciation of assets occupies a greater portion of the accruals. However, the depreciation value is dependent on the historical cost of the fixed assets. Hence, the Jones' Model estimates the non-discretionary accruals as follows:

$$NDA_{i,t} = \widehat{a}_1 \left(\frac{1}{AT_{i,t-1}} \right) + \widehat{a}_2 \left(\frac{\Delta REV_{i,t}}{AT_{i,t-1}} \right) + \widehat{a}_3 \left(\frac{GPPE_{i,t}}{AT_{i,t-1}} \right) \dots \dots \dots \text{eqn 1}$$

Where $NDA_{i,t}$ = non-discretionary accruals for firm i in year t ,

$AT_{i,t-1}$ = total assets employed by firm i in year $t-1$,

$\Delta REV_{i,t}$ = change in sales for firm i in year t ,

$GPPE_{i,t}$ = Gross plant, property, and equipment for firm i in year t ,

The coefficients \widehat{a}_1 \widehat{a}_2 and \widehat{a}_3 are estimates from the equation below:

$$TACC_{i,t} = a_1 \left(\frac{1}{AT_{i,t-1}} \right) + a_2 \left(\frac{\Delta REV_{i,t}}{AT_{i,t-1}} \right) + a_3 \left(\frac{GPPE_{i,t}}{AT_{i,t-1}} \right) + e_{i,t} \dots \dots \dots \text{eqn 2}$$

Where $TACC_{i,t}$ is the total accruals for firm i , in year t ,

a_1 , a_2 and a_3 are estimated values represented as \widehat{a}_1 , \widehat{a}_2 and \widehat{a}_3 , respectively, and

$e_{i,t}$ Signifies DACC for firm i , in year t .

The regressors in equation 1 are scaled by lagged assets to control for heteroskedasticity in residuals. The coefficients in equation 1 can be calculated using the cross-sectional data²⁷ or time-series data²⁸ of every firm. In general, researchers prefer the cross-sectional estimation because of the greater number of available observations. This study adopts the cross-sectional method on the assumption of the Jones' cross-sectional method that similar industry is likely going to have a similar operational feature that makes their estimated variables similar. Furthermore, this study is a cross country study, thus treats firms as contributing to a particular country and not emphatically to their industries.

The residuals from equation (1) give the value for the DisAcc. For it to be a reliable and unbiased estimate, the residuals are assumed to be orthogonal to the regressors in Equation (2). This is specifically the case when the regressors correlate with the measurement errors. Furthermore, omitted variables can make the model specification to be biased. The Jones model has been criticised for assuming that entire revenue can be accounted for non-discretionarily; however, account receivables can be subject to earnings management. Furthermore, return

²⁷ As used in Xie (2001); Klein (2002); Zang (2012)

²⁸ As used in Jones (1991); Dechow *et al.* (1995)

inward allowance on sales are entirely at the discretion of managers. Also, where account receivable increases, some managers can ‘borrow’ future sales (Kang and Sivaramakrishnan 1995).

Due to the weakness of Jones Model, Dechow *et al.* (1995) came up with the Modified Jones Model (MJM) compensates build on the weakness of Jones Model by incorporating the non-discretionary discretionary revenues in the computation of the non-discretionary accruals. The modified equation then becomes:

$$NDA_{i,t} = \widehat{a}_1 \left(\frac{1}{AT_{i,t-1}} \right) + \widehat{a}_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{AT_{i,t-1}} \right) + \widehat{a}_3 \left(\frac{GPPE_{i,t}}{AT_{i,t-1}} \right) \dots \dots \dots \text{eqn 3}$$

Where $\Delta REC_{i,t}$ signifies changes in account receivables for firm i in year t. Other variables are as earlier defined.

The coefficients of equation 3 are used in estimation discretionary accruals on the assumption that there is no manipulation of credit sales during the accounting period. Also, that change in the account receivable is reflected in a change in revenue.

On the other hand, the modified Jones model’s total accruals can be estimated using equation 4 below:

$$TACC_{i,t} = a_1 \left(\frac{1}{AT_{i,t-1}} \right) + a_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{AT_{i,t-1}} \right) + a_4 \left(\frac{GPPE_{i,t}}{AT_{i,t-1}} \right) + e_{i,t} \dots \dots \dots \text{eqn 4}$$

Similar to the Jones model, the residuals from Equation (4) signifies the DisAcc (Jones *et al.*, 2008; Kothari *et al.*, 2005). Nevertheless, the Jones Model and its modified version have been criticised on the basis that they can be misspecified. However, they are popularly used by researchers in estimating discretionary accruals due to the absence of

‘superior’ model (Guay *et al.*, 1996). In addition, a number of studies have attempted to improve the accrual models.

Kothari Model

In a bid to improve on the modified Jones Model, Kothari *et al.* (2005) argue for the need for an intercept and a measure of performance in the model. The omitted intercept and measure performance in the modified Jones model will result in the accrual model misspecification error. Hence, Kothari *et al.* (2005) emphasise the inclusion of a constant to avoid this problem. They also recommend the random walk feature of change in sales such that subsequent year’s change in sales should be equal to zero. Where the random walk phenomenon is missing, the estimation of discretionary accrual is likely going to be predisposed.

Future sales can be estimated from the trend of past sales. Also, Kothari *et al.* (2005) argue that the past performance of a firm influence the extent of the reliability of its future performance and accruals. Hence the following they proposed the following models in estimating discretionary accruals:

$$TACC_{i,t} = a_1 + a_2 \left(\frac{1}{AT_{i,t-1}} \right) + a_3 \left(\frac{\Delta REV_{i,t}}{AT_{i,t-1}} \right) + a_4 \left(\frac{GPPE_{i,t}}{AT_{i,t-1}} \right) + a_5 ROTA_{i,t(t-1)} + e_{i,t}$$

Where $ROTA_{i,t(t-1)}$ connotes net income over total assets; where total asset employed can either be current years ($ROTA_{i,t}$) or immediate previous year ($ROTA_{i,t-1}$). Kothari *et al.* (2005) argue that the current year version of the ROTA ($ROTA_{i,t}$) is more effective because it results in less misspecified tests. Therefore, this thesis adopts the current year performance measure- $ROTA_{i,t}$ to calculate the performance-based discretionary accruals instead of prior year’s return on total asset ($ROTA_{i,t-1}$). Every other variable is as defined earlier. The research of Kang and Sivaramakrishnan (1995) empirically support the efficiency

of the performance matched model. They also argue that type 1 error is significantly higher and proportionate to increase or decrease in ROTA.

Researchers favour the performance matched discretionary accruals model because it outwits other models considering its explanatory power. Furthermore, it is easy to compute as a benchmark firm will not be needed. However, the linearity of the relationship between accruals and ROA is necessary; otherwise, it might be difficult to arrive at a reliable estimate of the discretionary accruals. Therefore, Kothari *et al.* (2005) suggest the performance-matched discretionary accruals using the Jones model. Nevertheless, the model does not guarantee an absolute exemption from misspecification issues. That the performance-matched model uses the Jones model as a basis, makes it easy for researchers to use (Kothari *et al.*, 2005).

Therefore, this study measures discretionary earnings management using the popular modified Jones model, the standard Jones model and performance matched model used as dependent variables. Hence, the econometric models are designed to:

- (a) Test the hypotheses using both the firm and country-level variables as well as the interactive variable for each of the earnings management model
- (b) Test the hypotheses using both the firm and country-level variables as without the interactive variable for each of the earnings management model
- (c) Test the hypotheses using firm-level variables alone for each of the earnings management models
- (d) Test the hypotheses using country-level variables alone for each of the earnings management models.

5.2.1 Discretionary Accruals

Discretionary accrual is widely used in accounting literature to evaluate the extent of earnings management. Some researchers estimate discretionary accruals through total accruals and by comparing the figures of accruals among different firms. Another approach measures earnings management as a function of differences in the total accruals between reporting periods. This is usually computed on the assumption that non-discretionary accruals remain constant between periods and that the change in total accruals is traceable to management's discretion.

Alternatively, the estimated non-discretionary accrual might be adjusted to mirror the firm's growth. The last approach separates the total accruals into discretionary and non-discretionary components using regression analysis as used in the Jones (1991) model. It is popularly used due to its ability to analyse total accruals into discretionary and non-discretionary components

Further, Dechow *et al.* (1995) propose the modified Jones model (1995). The model allows changes in sales to be adjusted to reflect the change in receivables. The modified Jones model has been credited for its capacity to reduce the measurement error of estimating discretionary accruals, especially where the discretion is used on sales value. Although the model has been criticised as not useful in determining the discretionary accrual in Korean firms (Yoon *et al.*, 2006), Dechow *et al.* (1995) argued that the modified Jones model is better than other models as far as testing for earnings management is concerned.

Further, Guay *et al.* (1996) argue that both the Jones and modified Jones models measure discretionary accruals more reliably than other models. Using the modified Jones model ensures a more powerful test for earnings management that involves sales and bad debts manipulation (Peasnell, Pope and Young, 2000). In their study, Dechow *et al.* (1995) find that the modified Jones model detects sales related earnings

management more reliably than the standard Jones model. Therefore, this study adopts the modified Jones model in estimating the extent of earnings management among sampled firms. The justification for this choice is not only its popularity but because it controls for the tendency of managing earnings through revenues by adjusting for the change in revenue concerning change in receivables (Zeghal *et al.*, 2012). Aside from this, it has been established in the literature that modified Jones model is more effective at detecting earnings management than the standard Jones model (Islam *et al.*, 2011; Doukakis, 2014 and Swai, 2016).

This study starts the measure of earnings management with discretionary accruals with different earnings management models to observe the sensitivity of the diversity of the EM model to the research results. Based on the approach highlighted above, the following are the econometric models used in measuring discretionary accruals earnings management in this study.

$$\begin{aligned} \text{(a) } DiscAcc (EM^{29}) = & \beta_0 + \beta_1 IFRS(1,0) + \beta_2 DISSUE_{it} + \\ & \beta_3 EISSUE_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} + \beta_6 ROTA_{it} + \\ & \beta_7 LEV_{it} + \beta_8 GROWTH_{it} + \beta_9 SIZE_{it} + \beta_{10} AUD(1,0)_{it} + \\ & + \beta_{11} GDP + \beta_{12} HDI + \beta_{13} ECOSTAT + \beta_{14} GOVind + \\ & \beta_{15} IFRSGOV + \beta_{16} IFRSHDI + \beta_{17} IFRSECO + \\ & \beta_{18} IFRSAUD + \varepsilon_{it} \dots \dots \dots \text{equation (1)} \end{aligned}$$

$$\begin{aligned} \text{(b) } DiscAcc (EM) = & \beta_0 + \beta_1 IFRS(1,0) + \beta_2 DISSUE_{it} + \\ & \beta_3 EISSUE_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} + \beta_6 ROTA_{it} + \\ & \beta_7 LEV_{it} + \beta_8 GROWTH_{it} + \beta_9 SIZE_{it} + \beta_{10} AUD(1,0)_{it} + \end{aligned}$$

²⁹ The EM in either the Modified Jones Model or Jones Model or the Performance Matched Model as reported in the analysis chapter

$$+\beta_{11}GDP + \beta_{12}HDI + \beta_{13}ECOSTAT + \beta_{14}GOVind + \varepsilon_{it}.....equation (2)$$

$$(c) DiscAcc (EM) = \beta_0 + \beta_1IFRS(1,0) + \beta_2DISSUE_{it} + \beta_3EISSUE_{it} + \beta_4TURNOVER_{it} + \beta_5CFO_{it} + \beta_6ROTA_{it} + \beta_7LEV_{it} + \beta_8GROWTH_{it} + \beta_9SIZE_{it} + \beta_{10}AUD(1,0)_{it} + \varepsilon_{it}.....equation (3)$$

$$(d) DiscAcc (EM) = \beta_0 + \beta_1IFRS(1,0) + \beta_2GDP + \beta_3HDI + \beta_4ECOSTAT + \beta_5GOVind + \varepsilon_{it}.....equation (4)$$

ECOSTAT will be redundant while analysing developed and emerging economies separately. Also, IFRS in the country inclined variables indicates the decision to adopt IFR.

While measuring the accounting quality of a firm, earnings management and earnings smoothing³⁰ are often used to assess the accounting quality due to their influence on the reported earnings (Liu *et al.*, 2011; Chin *et al.*, 2009; and Liou and Yang, 2008). Earnings smoothing is a variation of earnings management, whereby managers deliberately reduce fluctuations of the reported earnings of their firms (Nagy and Neal, 2001; Trueman and Titman, 1988). Smoothed earnings are an indication of reduced quality of earnings. The variant of earnings smoothing is net income variability. Consistent with prior studies (Zeghal *et al.*, 2012; Ahmed *et al.*, 2013; Christensen *et al.*, 2015; Capkun *et al.*, 2016), this study adopts the following metrics to test the degree of earnings management of the sampled firms: discretionary accruals, variability of net income, variability of

³⁰ Earnings smoothing is a measure of earnings quality that reveals the extent that accounting standards allows managers to reduce variability of the net income by altering the accruals for the purpose of achieving capital market benefits (Zeghal *et al.*, 2012; Leuz *et al.*, 2003). Earnings management and earnings smoothing are often used interchangeably in the literature (Zeghal *et al.*, 2012; Capkun *et al.*, 2016).

CFO, earnings management towards targets (SPOS), earnings management towards conditional conservatism and timeliness (LNEG). This is measured by the change in net income scaled by the total asset for the year. This measure is used in Zeghal *et al.* (2012), Paananen (2008), Barth *et al.* (2008) and Lang *et al.* (2006). Lower change in the net income variability is an indication of reduced quality of reported earnings.

Another variant of earnings smoothing is the ratio of the variance of change in the net income to the variance of change in the operating cash flows. This ratio seeks to ensure that the volatility of earnings is not as a result of the volatility of operating cash flow. In other words, it measures the sensitivity of the change in net income to the variability of change in cash flow (Barth *et al.*, 2008; Zeghal *et al.*, 2012; Paananen, 2008).

Following prior studies,³¹ this study measures financial reporting quality through earnings management proxied on discretionary accruals, the variability of net income, managing net income toward small positive income, managing earnings towards avoiding reporting excessive losses and variability of cash flow.

5.2.2 Variability in Net Income

This measure of earnings quality is the change in net income divided by total assets. A small variance of the change in net income is an indication of earnings smoothing.. Because the measure can also be affected by other factors unrelated to earnings smoothing, the variability of net income is the variance of the residuals from the regression resulting from a change in net income over the control variables. Therefore, about the adoption of IFRS, accounting standards

³¹ Such as Barth *et al.* (2006); Lang *et al.* (2006); Paananen and Lin, (2009), Liu *et al.* (2011).

that discourage discretionary earnings management will result in increased variability of earnings (Ewert and Wagenhofer, 2005). This measure is also used in Barth *et al.* (2008), Paananen (2008) and Leuz *et al.* (2003). Below is the model that expresses the measure:

$$\Delta NI = \beta_0 + \beta_1 IFRS(1, 0) + \beta_2 DISSUE_{it} + \beta_3 EISSUE_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} + \beta_6 LEV_{it} + \beta_7 GROWTH_{it} + \beta_8 SIZE_{it} + \beta_9 AUD(1, 0)_{it} + \beta_{10} GDP_{it} + \beta_{11} HDI_{it} + \beta_{12} GOVind_{it} + \varepsilon_{it} \dots \dots \dots \text{equation (2)}$$

5.2.3 Variability of Net Income towards Small Positive Profits (SPOS)

The literature documents this as a common earnings management practice of managers while trying to manage earnings towards a target. In order not appear as a failure in their stewardship role, they will prefer to report a small profit rather than negative net income. Therefore, consistent with Barth *et al.* (2008) and Leuz *et al.* (2003), SPOS is used as a dummy variable. Where annual income scales by total assets is within the range of 0 and 0.01, SPOS is given 1 as an indicator and 0 if otherwise. The model below demonstrates the use of variability in the net income towards small positive income:

$$\Delta NI_SPOS = \beta_0 + \beta_1 IFRS(1, 0) + \beta_2 DISSUE_{it} + \beta_3 EISSUE_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} + \beta_6 LEV_{it} + \beta_7 GROWTH_{it} + \beta_8 SIZE_{it} + \beta_9 AUD(1, 0)_{it} + \beta_{10} GDP_{it} + \beta_{11} HDI_{it} + \beta_{12} GOVind_{it} + \varepsilon_{it} \dots \dots \dots \text{equation (3)}$$

5.2.4 Variability of Net Income towards Timely Loss Recognition (LNEG)

Consistent with Barth *et al.* (2008) and Capkun *et al.* (2016), we tested for the variability of the reported net income towards timely loss recognition. To identify the tendency that a firm would avoid reporting a significant loss, a dummy variable of 1 is used to represent where the

net income scaled by the average total asset is less than -0.20 and otherwise, 0. A negative coefficient in the regression implies that net income is increased towards avoidance of reporting the net loss and vice versa. Furthermore, increased frequency of reported earnings in large losses is an indication of a high-quality reporting (Lang *et al.*, 2006). This implies that losses are recognised as they occur and are not deferred. Hence, the equation below:

$$\begin{aligned} \Delta NI_LNEG = & \beta_0 + \beta_1 IFRS(1, 0) + \beta_2 DISSUE_{it} + \\ & \beta_3 EISSUE_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} + \\ & \beta_6 LEV_{it} + \beta_7 GROWTH_{it} + \beta_8 SIZE_{it} + \beta_9 AUD(1, 0)_{it} + \\ & \beta_{10} GDP_{it} + \beta_{11} HDI_{it} + \beta_{12} GOVind_{it} + \varepsilon_{it} \dots \text{equation} \\ & (4) \end{aligned}$$

5.2. 5 Variability of Cash flow from Operation

Prior studies document that earnings management can also be done through the variability of the cash from operations. This test variable measures the extent of earnings management on the adoption of the IFRS:

$$\begin{aligned} \Delta CFO = & \beta_0 + \beta_1 IFRS(1, 0) + \beta_2 DISSUE_{it} + \beta_3 EISSUE_{it} + \\ & \beta_4 TURNOVER_{it} + \beta_5 ROTA_{it} + \beta_6 LEV_{it} + \beta_7 GROWTH_{it} + \\ & \beta_8 SIZE_{it} + \beta_9 AUD(1, 0)_{it} + \beta_{10} GDP_{it} + \beta_{11} HDI_{it} + \\ & \beta_{12} GOVind_{it} + \varepsilon_{it} \dots \text{equation (5)} \end{aligned}$$

5.2.6 Proportion of Change in Net income to Change in Cash Flow from Operation

This test variable for earnings management also emphasises timely recognition of losses and gains. It is an expression of the volatility of the net income as influenced by the change in cash flow (Ball *et al.*, 2006):

$$\frac{\Delta NI}{\Delta CFO} = \beta_0 + \beta_1 IFRS(1, 0) + \beta_2 DISSUE_{it} + \beta_3 ISSUE_{it} + \beta_4 TURNOVER_{it} + \beta_5 CFO_{it} + \beta_6 ROTA_{it} + \beta_7 LEV_{it} + \beta_8 GROWTH_{it} + \beta_9 SIZE_{it} + \beta_{10} AUD(1, 0)_{it} + \beta_{11} GDP_{it} + \beta_{12} HDI_{it} + \beta_{13} GOVind_{it} + \varepsilon_{it} \dots \dots \dots \text{equation (6)}$$

5.3 Validity and Reliability

To ensure the accuracy of the results, the validity test assesses the measuring methods to verify whether they measure what they intend to measure or not (Ejvegard, 2009). Two main types of validity are commonly identified in quantitative studies: internal and external validity.

The internal validity measures the extent to which the independent variable explains the dependent variable. Since the purpose of this study is to assess how the IFRS has reduced EM among countries and to check if such change has implications for the economic status of such countries, the internal validity is of paramount importance if the results are to be generalisable. Different models have been used and tested by scholars in the literature to establish their validity and replication in further research of this sort. Example of this is the modified Jones model. Although the models do not allow us to assume the possibility of EM being practised by countries, the results are pointers to this. In the opinion of Bryman and Bell (2003), cross-sectional studies often present low internal validity results. However, it was popularly used by prior authors and thereby adopted to help the comparison of results with prior research and for the flow of research knowledge. As a matter of emphasis, the authors accept that refusing to consider competing explanations of research outcomes is a threat to internal validity.

For a firm to country-level research like this, there may be a change in the firm and the country due to IFRS adoption, especially during the

year of its adoption. If these are not adequately controlled for, the research result will suffer severe internal validity issues, and the results cannot be generalised. Hence, consistent with prior authors, the mandatory IFRS adoption year (2005) was excluded in the analysis of the developed economies (Holthausen, 2009; Buggerman *et al.*, 2013).

External validity focuses on the replicability of the study. This is commonly high in a cross-sectional study (Bryman and Bell, 2003). The countries chosen are those that adequately represent the economic classifications so that the purpose of the research is achieved efficiently, and the generalisation of the result can be without bias. Although some firms were excluded from the sample due to lack of data for the research period 1995-2015, industries such as real estate and banking were also excluded. I adjudge this study to have acceptable external validity, having conducted my research on a representative sample.

This thesis does not only examine a large sample of firms to enhance the generalizability of research results, but it also examines each firm thoroughly with the help of the model adopted. Hence both the internal and external validity of this research is considered satisfactory. Construct validity assesses the extent to which a model measures what it claims to measure.

Reliability assesses whether the study will yield the same result if it were to be carried out again. Therefore, a poorly executed research, having excellent and valid measurement methods will still yield incorrect results (Bjereld *et al.*, 2002). Hence, for higher reliability, any random or temporary circumstances that might compromise the research result must be avoided (Bryman and Bell, 2003). Furthermore, construct validity tests whether the chosen model accurately measures what it is purposely designed to measure or whether it measures another thing (Smith, 2011).

On the premise that the data used in this study were collected from reliable databases to reduce human errors, the repetition of the research process will lead to the same research result. In addition to this, I have reviewed and applied the practical steps of prior authors in a similar field to ensure the reliability of research results (Zeghal *et al.*, 2012; Zang, 2011; Sellami *et al.*, 2014). Adopting a research design that has been earlier used and tested ensures there is the tendency of the reliability of this study being high. According to Smith (2011), high reliability will result in low construct validity. Contrary to this, our model is purposely designed to measure the extent of earnings management as has been tested by prior researchers, so the construct validity is therefore high. In addition to this, the statistical signals of the results provide further evidence for reliability.

On the replicability of the research results, the process to the research results was described to ensure they are scientifically accurate and to enable other researchers to replicate the same steps. Replicability is often tested, especially when the research results differ from those of prior studies (Bryman and Bell, 2003). In such a case, the future researcher may need to adapt the process and see if the results generated are similar or not.

5.4 Econometric Issues with Cross-sectional Studies

This section explains how this thesis overcomes econometric issues such as endogeneity, heteroskedasticity, and autocorrelation that can affect the reliability of the research results. A cross-sectional study is not without its challenges. Nevertheless, this study strives to reduce this to the barest minimum so that the test power and research credibility can be boosted. A sample of dead and alive companies was used in the study to moderate survival bias (Foster, 1986, p. 75-96). The sample includes all observations with adequate data to analyse the required variables. However, the reliance on a single source of data might make

the result from the study have limited applicability. Privately owned firms are excluded from the study. In the same vein, sectors such as financial and real estate sectors are excluded due to the nature of their reporting system and their volatility, respectively. This is in line with prior studies.

Endogeneity

While running a multivariate regression, one of the major econometric issues is the simultaneity bias (endogeneity). If ignored, estimates from the regression equation become biased and misleading. Endogeneity problems occur when independent variables are correlated with the noise in the regression model. While the endogenous variables often assume the position of the dependent variable, the exogenous variables are the regressors (independent variable) in the model. The underlying assumption concerning this is that such regressors are not correlating with the error term in that model (Gujarati, 2015). According to Baltagi (2008), the possible causes of endogeneity are biased sample selection, measurement error or non-incorporation of relevant variables. This thesis adopts the Wu-Hausman test to check for endogeneity issues. In addition to endogeneity, autocorrelation and heteroskedasticity issues, the next session discusses further econometric issues such as autocorrelation and multicollinearity. Also, this study uses the system GMM to ensure that the estimates devoid of endogeneity issues.

Autocorrelation

Apart from endogeneity issues, a reliable inference can only be made from research results where autocorrelation among the error terms is controlled for. When this is not considered biased estimates of coefficient and standard errors from the OLS are inevitable. According to Sarafidis *et al.* (2009), these types of a diagnostic test can be used to test for the existence of serial correlation in panel data: the CD test by proposed by Pesaran in 2004 and the Lagrange Multiplier test proposed

by Breusch and Pagan in 1980. This study adopts the two tests to check for potential serial correlation in the model. Since the result of this study revealed serial correlation in the model, further checks, including one or more of the following could be adopted:

1. Running the model using the GMM estimator system (Petersen, 2009). This is further discussed in the latter section.
2. Correcting heteroskedasticity and autocorrelation issues using the Newey robust standard error (Gujarati, 2015, Yaffee, 2003), using generalised least squares (Hansen, 2007).
3. Ensuring that standard errors clustered by firm and time are stated.

Multicollinearity Issues

One of the basic assumptions of the linear regression model is its prediction of the value of the dependent variable (Y) as a weighted sum of the independent or explanatory variables (X_i) and the random error (ϵ). Multicollinearity emerges when the independent variables in a regression model correlate with each other (Graham, 2005). As argued by Graham (2005), analysing the correlated variables might be cumbersome as the synergistic association might have caused this multicollinearity among the variants. The situation becomes worse if the variables are genuinely inferential. Therefore, to identify multicollinearity among the variables in the models, this thesis uses a Pearson correlation matrix and the variance inflation factor. According to Sine (1995), there is no universal estimate for large VIF. However, a threshold of 10 could be an extreme indication of multicollinearity while between 5 and 10 indicates a potential multicollinearity problem. Based on the argument of Siregar and Utama (2008), multicollinearity problems exist if the VIF is greater than 10. In this thesis, most of the explanatory coefficients in the Pearson correlation are less than 0.7

indicating that there is no serious multicollinearity problem in the analyses. Also, none of the VIF though out all the analyses exceeded 5.

Missing Data and Outliers

Apart from treating missing data, this study detects and removes outliers. Chen *et al.* (2015) describe an outlier to be an observation that is unusually larger than the standard deviation of its sample distribution. Furthermore, Cousineau and Chartier (2010) define outliers as unusual observations that are significantly lower or higher than most of the observations. Such can impair the research result. The literature documents diverse treatment of outliers by earnings management authors: the trimming method (as used in Bukit and Iskandar, 2009; Robin and Wu, 2012; and Zamri *et al.*, 2013) and the winsorization method as used in (Hribar and Nichols, 2007; Barth *et al.*, 2008 and Gunny, 2010). Although the winsorization technique has been criticised for not being an absolute solution to outliers, it, however, reduces its effect to the barest level. According to Lien and Balakrishnan (2005), the goodness of fit and the accuracy of the estimated slope are reduced. They also argue that the trimming method is not affected by the regression slope and the mean square error. However, winsorization technique widely used in finance and recent accounting literature has argued that it is more accurate than the trimming method (Adam *et al.*, 2018). Therefore, following Barth *et al.* (2008) and Lang *et al.* (2006), all data are winsorized at 99% and 1% to reduce the effect of outliers.

Heteroscedasticity

This research addresses heteroscedasticity challenges in addition to controlling for autocorrelation issues. This results in getting unbiased, efficient and consistent estimators for the OLS model. Where heteroscedasticity is not properly controlled for, the standard errors would be inaccurate, thereby leading to incorrect inferences. Having used STATA 14 to run the regression, the results indicate rejection of

the null hypothesis of the heteroscedasticity. Hence, White's heteroscedasticity was adopted in reporting the results. This is also known as the robust standard errors. This thesis incorporates the robust feature of the STATA command in the regressions to generate the Huber-White standard errors while controlling for heteroscedasticity.

I faced the challenge of deriving some gross value of Property Plant and Equipment as they are mostly reported in their 'net' form. I, however, overcome this by adding the depreciation value for the year to the net PPE to obtain the gross value.

To minimise standardisation and comparability problems, I used countries that adequately represent the economic classification in the study and assume that countries selected used standardised accounting system. To eliminate currency bias, it is assumed that the reporting currency of firms was one of the seven major currencies. The firm-specific residuals are calculated and derived from the regression using the STATA 14 to minimise handling errors were handled manually. However, when manual methods were used to derive the residuals, the SPSS outputs yielded the same result. The time frame adopted (1995-2015) is for the pre and pre-IFRS adoption impact and the trend of the phenomenon to be well examined.

5.5 Operationalisation of Variables

This study adopts the cross-sectional model as developed by Jones (1991) and used by Dechow *et al.* (1995) and its modified version and the performance matched model (Kothari *et al.*, 2005). However, the study prioritises the modified Jones model due to prior studies that considered it as a better measure of earnings management. The popularity of this model in the current literature in estimating discretionary accruals as a measure of earnings management makes it attractive to this study. This is further justified by the fact that the results of this research can be easily compared with those of prior authors and

for inferences given by an accurate measure of earnings management. Also, the model allows variations in the economic circumstances as related to each industry and changes in the value of the coefficients to be well observed over time (Ipino and Parbonetti, 2011; Sellami and Fakhfakh, 2014). This thesis pooled all data relating to industries for each of the countries together. Hence, it is a country inclined study. Using the cross-sectional approach and the modified Jones model, the total accrual can be estimated using the following equation:

$$\frac{TAcc_{c,t}}{TA_{c,t-1}} = \beta_0 \left(\frac{1}{TA_{c,t-1}} \right) + \beta_1 \frac{(\Delta Rev_{c,t} - \Delta Rec_{c,t})}{TA_{c,t-1}} + \beta_2 \left(\frac{GPPE_{c,t}}{TA_{c,t-1}} \right) + \varepsilon_{c,t}$$

..... (1)

The following procedure is used in estimating the discretionary accrual:

- i. Estimate the total accruals for each observation. Total accrual is the difference between net income before, extraordinary items, interest and tax and the cash flow from operations. Mathematically expressed:

$$TAcc = EBXI_{c,t} - CFO_{c,t}$$

..... (2)

Where TAcc is the total accruals of all companies in industries in a country in year t

$EBXI_{c,t}$ is the earnings before extra-ordinary items and $CFO_{c,t}$, operating cash flows.

- ii. Calculate the level of non-discretionary accruals (NonDA) for each observation following the equation below:

$$\frac{NonDA_{c,t}}{TA_{c,t-1}} = \beta'_0 \left(\frac{1}{TA_{c,t-1}} \right) + \beta'_1 \frac{(\Delta Rev_{c,t} - \Delta Rec_{c,t})}{TA_{c,t-1}} + \beta'_2 \left(\frac{GPPE_{c,t}}{TA_{c,t-1}} \right) \dots \dots \dots (3)$$

- iii. Discretionary accrual can be computed by finding the difference between total accrual (TAcc) and non-discretionary accruals.

All the variables are scaled by the value of total assets at the beginning of the period to control for heteroscedasticity. Thus, the estimate of discretionary accruals is the error term in the regression equation i.e. $\varepsilon_{c,t}$. In order to calculate discretionary accruals, the total accrual for each observation has to be calculated, as mentioned above. Then the level of non-discretionary accruals for each of the observations can be established by adopting co-efficient estimates (β'_0 , β'_1 , β'_2) as expressed in the equation above.

5.6 Summary

In summary, earnings management on the adoption of IFRS could be expressed as a function of corporate governance factors as stated above, economic status and other control variables such as debt and the company size. Building on prior studies, the chapter looked into what has been empirically done and development of models right from their origins. The purpose of this is to identify what further things need to be done and the application of what has been done to the present study. Countries selected for study are countries that have earlier been researched so that the result obtained from the study could be easily compared. In the next chapter, data is analysed using both pooled OLS and Panel data regression to analyse the data for robustness purposes.

Chapter Six: Data Analysis and Empirical Findings

6.0 Introduction

The adoption of IFRS was mandated among the EU and some developed countries in 2005. However, the emerging economies, adopted the standard at different dates, mostly after 2005, some are yet to adopt the standard. This has attracted many academic debates, just as mixed findings exist in the literature on the impact of the IFRS on the quality of reported earnings.

IFRS came as an initiative of the EU to compete for global capital better than their US counterparts (Capkun *et al.*, 2007). It was not intended for countries outside the European Union in the first place. It was a 'repackaged' IAS domiciled and practised in the developed world. Based on this, it is easier for countries in this setting to adopt IFRS than for the emerging economies whose accounting systems dwell more on their local GAAP. Following wholesale adoption in emerging economies, this section discusses the efficacy of the IFRS based on the quality of reported earnings.

Looking at it from the perspective of where IFRS started from and where it has permeated to, it may be assumed that the impact of the adoption of IFRS cannot be equal just as, all things being equal, the extent of earnings management among firms in sampled countries and the economic status of adopting countries differs. This study intends to draw an inference from results from the secondary financial data of active firms that witnessed the two eras. The justification behind this is that each firm would have engaged and mastered the standards well enough. Further, a disproportionate contribution to research results would be avoided.

The results from this section will also reveal the economies (developed or emerging) that practise more earnings management. Also, it examines whether the degree of earnings management practised by countries correlates with their economic status on the adoption of IFRS. Furthermore, with the on-going popularity of the standards and non-compliance by the US, this thesis examines the tendency of IFRS to gaining greater acceptance by countries of the world.

This chapter is divided into three sections. The first section analyses and discusses the results of firms from both developed and emerging economies in order to examine the general efficacy of the IFRS on financial reporting quality. The pooled data analysed in this section also

will provide insight into how the institutional and corporate infrastructure could promote or reduce earnings management. Also, it would help in having a comparative view of earnings management for each of the economies regarding the period of study.

6.1 Discussion of Analyses Relating to the Combined Data of Both Developed Economies and Emerging Economies.

The study is based on 21,588 observations from 1,028 firms over 21 years. The period was chosen to follow the research conversation of the impact of IFRS adoption on earnings quality after 10 years, as advanced by Ball (2016). I decided to work back by including 10 years before the adoption of the standard to make a balanced contribution to the research experience. Data collected on firms in the selected countries of both developed and emerging status were pooled together and analysed. A dummy variable, ECOSTAT (economic status), was created to differentiate the data from developed economies from the data from emerging economies. Therefore the next sessions discusses the descriptive statistics, correlation matrix and the multivariate regression results of the pooled data of firms from both developed and the emerging economies. The descriptive statistics of all variables (apart from the dummy variable) used in this is presented in table 6.1 below.

Table 6.1 Descriptive Statistics for Earnings Management Model Variables

Variable	Developed Economies					Emerging Economies							Both Economies				
	Mean	Median	Std. Dev.	Min	Max	Mean	Median	Std. Dev.	Min	Max	Mean Diff	T-Statistic	Mean	Median	Std. Dev.	Min	Max
DisAccMJM	-0.029	-0.019	0.098	-0.526	0.365	-0.044	-0.034	0.153	-0.526	0.365	0.015	(8.664)***	-0.036	-0.024	0.122	-1.238	0.587
ABSDisMJM	0.069	0.044	0.085	0.001	0.644	0.120	0.082	0.122	0.001	0.644	-0.051	(-44.753)***	0.092	0.060	0.100	0.001	1.238
DisAccJM	-0.086	-0.056	0.141	-0.656	0.295	-0.032	-0.016	0.133	-0.656	0.295	-0.054	(-28.856)***	-0.056	-0.034	0.132	-1.689	0.496
DisAccPMM	-0.274	-0.176	0.286	-1.140	0.427	-0.022	0.026	0.233	-1.140	0.427	-0.252	(-70.480)***	-0.138	-0.068	0.279	-2.929	0.740
DISSUE	0.106	0.033	0.404	-0.731	2.872	0.149	0.072	0.483	-0.731	2.872	-0.043	(-7.119)***	0.112	0.051	0.369	-0.845	5.533
EISSUE	0.087	0.064	0.377	-1.174	2.294	0.105	0.071	0.399	-1.174	2.294	-0.018	(-3.407)***	0.087	0.068	0.326	-10.206	4.584
TURNOVER	1.162	1.060	0.707	0.059	4.247	1.053	0.831	0.831	0.059	4.247	0.110	(10.409)***	1.087	0.947	0.727	0.002	5.943
CFO	0.093	0.086	0.089	-0.169	0.439	0.080	0.069	0.096	-0.169	0.439	0.013	(10.323)***	0.086	0.078	0.088	-0.217	1.230
ROTA	0.048	0.047	0.082	-0.270	0.351	0.057	0.049	0.093	-0.270	0.351	-0.009	(-7.556)***	0.053	0.048	0.081	-0.504	0.553
LEV	1.901	1.265	2.343	-3.397	14.782	1.525	1.027	2.086	-3.397	14.782	0.376	(12.395)***	1.626	1.136	2.044	-21.005	69.769
GROWTH	0.078	0.049	0.264	-0.700	1.876	0.122	0.096	0.356	-0.700	1.876	-0.044	(-1.134)**	0.094	0.069	0.276	-0.789	4.539
SIZE	13.198	12.973	2.371	8.834	19.559	14.936	14.838	1.967	8.834	19.559	-1.739	(-58.233)***	14.112	14.133	2.286	7.977	21.383
GDP	0.019	0.022	0.017	-0.055	0.050	0.063	0.068	0.034	-0.055	0.127	-0.044	(-2.588)**	0.042	0.033	0.036	-0.074	0.142
HDI	0.877	0.880	0.027	0.474	0.926	0.654	0.653	0.080	0.474	0.789	0.223	(5.906)***	0.759	0.776	0.127	0.460	0.939
GOVind	6.150	6.331	1.102	2.202	7.820	-0.242	-0.173	1.763	-2.649	2.255	6.392	(6.875)***	2.781	1.936	3.523	-2.676	8.073
Observations	10,206					11,382							21,588				

Table 6.1 presents the descriptive statistics of the models used in this study for measuring earnings management. The table is partitioned into four sections the mean, median, standard deviation minimum and the maximum values for the developed, emerging and both Economies respectively. The third section tests the differences in means of the developed country and emerging economies. The t-statistics are presented in brackets with the levels of significance indicated as ***, **, and * refer to the significance at the 1%, 5% and 10% levels of significance respectively. DisAccMJM refers to the discretionary accruals derived through modified Jones model. The ABSDisMJM is its absolute value. DisAccJM and DisAccPMM are discretionary accruals calculated using the standard Jones model and the Performance Matched model, respectively. DISSUE is the percentage change in long term debt, EISSUE is the percentage change in equity, Turnover is the total sales scaled by total asset employed, CFO measures the cashflow from operation, ROTA, the return on total asset, LEV is the proportion of the total liability to total equity. Growth signifies growth potentials and it is calculated by percentage change in Turnover. Size is the logarithm of total assets employed. GDP, HDI and GOVind are country level variables which indicate percentage growth rate of the gross domestic product, Human Development Index and Governance Indicator.

6.1.1 Discussion of Descriptive Statistics for Earnings Management Model Variables for all Countries

Table 6.1 presents the descriptive statistics of variables used in measuring earnings management and earnings quality in this study. The statistical values relating to the mean, median, standard deviation minimum and maximum values are presented for each of the economic classifications (developed economies and emerging economies) while a section of the table also present results data relating to the pooled data of both economies. Also, a section of the table reports the T-statistics testing the statistical significance of the difference between reported averages of the two economic classifications for the model variables. The mean, median, standard deviation, minimum, and maximum values are shown for the dependent and independent variables. Developed countries used in this study include Germany, Australia, France, Italy and the United Kingdom. Emerging economies studied include China, India, Malaysia, Brazil and South Africa.

The descriptive statistics reveal a negative discretionary accrual for both the developed and emerging economies in all the earnings management models used. However, the modified Jones model reveals a higher value of earnings management in favour of the developed economy than that of emerging economies. This might be due to the direction of earnings management mostly practised by each economic classification. For instance, if more of downward earnings management is done among firms in the developed economy for instance and more of upward earnings management is common with emerging economies or vice versa, such might explain this result. However, in absolute terms, the absolute discretionary accrual averages 6.9% and 12% for the developed and emerging economies respectively. The differences are all significant at 1% level. This implies that the level of earnings management between developed economies and emerging economies differs at 1% level of significance.

The table shows that on the average, the amount of long-term debt raised by developed economies is 10.6% and 14.9% in emerging economies. Also, the average value for equity raised for developed economies is 8.7% and 10.5% for emerging economies. This implies that firms from developed economies depend less on debt capital and equity than firms from emerging economies. The significant differences are both at 1% level of significance.

Average turnover and free cashflow from the operation are higher for developed economies than emerging economies. The differences are statistically significant at 1% level. However, the average return on total assets for the developed economies (4.8%) is lower than that of emerging economies (5.7%). The standard deviation also goes in the same direction. This implies that higher profitability and increased volatility of earnings are more pronounced with the emerging economies. The difference is also statistically significance at 1%. The average return on total assets employed for the emerging economies (5.7%) exceeds the average rate for all the economies (5.4%). The average leverage for the developed economies is higher and more statistically significant than emerging economies'. This implies that the developed economies have greater highly geared firms than emerging economies. The t-statistics revealed the difference to be statistically significant at 1%.

Furthermore, the descriptive statistics table shows that the emerging economies have a higher average rate (12.2%) of potential for growth than the developed economies (7.8%). The results regarding profitability, as discussed above, corroborate this. This is also reflected in the growth rate of the GDP of both economies. Logically, increased profitability enhances the growth opportunities of firms, and this would ultimately increase the rate of the gross domestic product of the countries in which they are domiciled.

Contrary to expectations, the average firm size (measured as the natural logarithms of the total assets) of emerging economies is higher than that of the developed economies, and the difference is at 1% level of significance. The average firm size of the emerging economies was also more than the average for the pooled economies. As expected, the average HDI of the developed economies is higher than that of the emerging economies'. The difference is also significant at 1%. The same experience was found regarding the governance and political index.

Overall, the table of descriptive statistics shows that the variability of net income and variability of free cash flow does not differ significantly between the two economies. However, the emerging economies were observed to have higher earnings management, increased debt finance, higher equity finance, and a higher rate of return on total assets, better growth opportunities, higher size and a higher rate of GDP. Also, the table revealed a significantly lower turnover, lower free cash flow from operation, lower leverage, lower human development and reduced governance and political index on the average.

Table 6.2 Correlation matrix and the VIF for Pooled Data of Both Emerging Economies and Developed Economies																
Variable	DisAcc	IFRS	DISSUE	EISSUE	TURN OVER	CFO	ROTA	LEV	GROWTH	SIZE	AUD	GDP	HDI	GOVind	ECO STAT	VIF
DisAcc	1															1.48
IFRS	-0.131***	1														1.2
DISSUE	-0.0126	-0.025***	1													1.42
EISSUE	0.0727***	0.00367	0.154***	1												1.4
TURNOVER	-0.034***	0.0363***	0.114***	0.150***	1											1.5
CFO	-0.233***	-0.04***	0.0773***	0.101***	0.182***	1										2.28
ROTA	0.205***	-0.0190**	0.145***	0.351***	0.252***	0.485***	1									1.45
LEV	-0.029***	0.0004	0.0296***	-0.099***	0.0594***	-0.107***	-0.231***	1								1.35
GROWTH	-0.0789***	-0.0728***	0.393***	0.280***	0.155***	0.0513***	0.230***	0.00822	1							1.85
SIZE	0.0854***	0.0137	0.0864***	0.0819***	-0.142***	0.0322***	0.0968***	0.157***	0.0870***	1						1.32
AUD	-0.0837***	0.0903***	0.00595	0.0234**	0.0686***	0.127***	0.0963***	0.0253***	-0.0111	-0.0027	1					2.63
GDP	0.0832***	-0.257***	0.0829***	0.0540***	-0.108***	-0.104***	0.0381***	-0.075***	0.149***	0.283***	-0.314***	1				3.87
HDI	-0.0270***	0.380***	-0.071***	-0.045***	0.0245***	0.0172*	-0.114***	0.0672***	-0.106***	-0.447***	0.284***	-0.614***	1			4.88
GOVind	-0.0405***	0.173***	-0.064***	-0.0193**	0.156***	0.112***	0.00528	0.0610***	-0.0956***	-0.454***	0.360***	-0.694***	0.664***	1		3.99
ECOSTAT	-0.0756***	0.218***	-0.0712***	-0.035***	0.0735***	0.0715***	-0.0501***	0.101***	-0.0997***	-0.384***	0.236***	-0.615***	0.679***	0.606***	1	
Table 6.2 presents the correlation matrix of the variables studied. ***, **, and * refer to 1%, 5% and 10% levels of significance respectively. DisAcc refers to the discretionary accruals derived through modified Jones model. IFRS is a dummy variable for adoption of IFRS. It takes the value of 1 if firms have adopted IFRS and 0 if otherwise. DISSUE is the percentage change in long term debt, EISSUE is the percentage change in equity, TURNOVER is the total sales scaled by total asset employed, CFO measures the cashflow from operation, ROTA, the return on total asset, and LEV is the proportion of the total liability to total equity. GROWTH signifies firm's growth potentials and it is calculated by percentage change in Turnover. SIZE is the logarithm of total assets employed. AUD refers to audit quality. It takes the value of 1 if firm is audited by any of the big four firm and 0 if otherwise. GDP, HDI and GOVind are country level variables which indicate percentage growth rate of the gross domestic product, Human Development Index and Governance Indicator. The ECOSTAT refers to the economic status. It takes 1 for developed economies and 0 for emerging economies.																
Source: Author																

6.1.2 Correlation Matrix for All Economies

The computed Pearson Correlation matrix is presented table 6.2 below. The table reveals the correlations between the dependent variable and the independent variables. The independent variable adopted for this purpose is the Modified Jones Model derived discretionary accruals. Others model were also tried and the results are consistent with that of Modified Jones Model. I, therefore, avoid repetition by focusing on modified Jones Model derived discretionary accrual for this purpose of all correlation in this study. According to table 6.2, all explanatory correlation coefficients are less than 0.7. This implies that no serious multicollinearity issue with the regression model. In addition to this, the VIF of all variables used are less than 10, a benchmarked set by Kennedy (1998) and Gujarati (1995). This re-emphasises that no multicollinearity problem exists in the regression analysis. Also, the VIF test has the highest value of 4.88 which suggest there is no multicollinearity among the variables.

The Pearson correlation table above reveals negative relationship between discretionary accrual and adoption of IFRS at 1% level of significance. This implies that earnings management reduces on adoption of IFRS by reporting firms. In addition, TURNOVER, CFO, LEVERAGE, GROWTH, AUD, HDI, GOVind and ECOSTAT all correlate negatively at 1% level of statistical significance. This implies that firms with high turnover might have less motivation for earnings management. Also, increased earnings management is claiming to be financially buoyant that as it is real. This is usually revealed through the volume of cash available for operation. Hence, where profits are managed upward, it would be exposed through reduced cash flow from operation. Furthermore, the negative association of discretionary accrual with LEVARAGE shows that increased gearing will lead to less of earning management practice. This might be because of close monitoring of creditor on the financial affair of the reporting firm. The

AUD implies that engagement of the Big Four audit firms reduces the level of earnings management practices among companies.

Furthermore, GOVind, as expected, good governance among countries should influence the accounting system of such thereby influencing the quality of reported earnings through reduced earnings management. A higher level of earnings management is identified with reduced human development (HDI). The negative and significant association between DisAcc and ECOSTAT indicate that earnings management is rampant among firms in emerging economies than among developed economies. The discretionary accruals, on the other hand, correlate positively with The EISSUE, ROTA, SIZE, and GDP. The EISSUE might be due to signalling effect. Where the ROTA is managed upward, an investor might misconstrue a non-viable company for a viable one and invest in their equity. This will increase the equity value of the reporting firm. The positive and significant association between discretionary accruals and Size is an indication that larger firms engage in earnings management more than smaller firms. Also, higher GDP is associated with increased earnings management.

6.1.3 Regression Results from Discretionary Accruals-Based Earnings Management Models used.

This section discusses the results of the pooled OLS regression of the pooled data of both developed and emerging economies on the three discretionary accruals-based earnings management models adopted: the Jones, Modified Jones Model and the Performance Matched (Kothari) Model. As mentioned earlier in the methodology chapter, Table 6.3 presents the results in two partitions: One for all variables Firm and country level and with interactive variables while the other section is without interactive variables.

**Table 6.3 Regression Table from Pooled OLS analyses of Both
Developed and Emerging Economies**

	Earnings management Models with Interaction variables			Earnings management Models without Interaction variables		
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	DisAcc_MJM	DisAccJM	DisAccPMM	DisAcc_MJM*	DisAccJM*	DisAccPMM*
IFRS	-0.145*** (0.0345)	-0.168*** (0.0356)	-0.198*** (0.0429)	-0.0106*** (0.00331)	0.00806*** (0.00294)	0.00974*** (0.00328)
DISSUE	0.00692** (0.00306)	-0.00256 (0.00299)	-0.0165*** (0.00355)	0.00701** (0.00308)	-0.00231 (0.00301)	-0.0162*** (0.00357)
EISSUE	-0.000439 (0.00452)	-0.000275 (0.00496)	-0.00904 (0.00739)	-0.000327 (0.00449)	-0.000466 (0.00495)	-0.00926 (0.00737)
TURNOVER	-0.0162*** (0.00139)	-0.0156*** (0.00118)	-0.0168*** (0.00138)	-0.0160*** (0.00139)	-0.0158*** (0.00118)	-0.0170*** (0.00139)
CFO	-0.623*** (0.0155)	-0.528*** (0.0175)	-0.513*** (0.0214)	-0.624*** (0.0155)	-0.529*** (0.0175)	-0.514*** (0.0214)
ROTA	0.738*** (0.0157)	0.619*** (0.0210)	1.519*** (0.0302)	0.739*** (0.0157)	0.620*** (0.0210)	1.520*** (0.0302)
LEV	0.00111*** (0.000331)	0.00123** (0.000563)	0.00133* (0.000800)	0.00103*** (0.000335)	0.00118** (0.000563)	0.00126 (0.000800)
GROWTH	-0.0710*** (0.00534)	-0.0431*** (0.00438)	-0.0498*** (0.00505)	-0.0712*** (0.00536)	-0.0426*** (0.00438)	-0.0493*** (0.00505)
SIZE	-0.00121*** (0.000353)	0.00823*** (0.000446)	0.00901*** (0.000525)	-0.00129*** (0.000353)	0.00808*** (0.000446)	0.00882*** (0.000526)
AUD	0.000574 (0.00186)	0.00917*** (0.00215)	0.00938*** (0.00251)	-0.00159 (0.00145)	0.0103*** (0.00161)	0.00965*** (0.00191)
GDP	-0.00449 (0.0469)	0.136*** (0.0450)	0.189*** (0.0535)	0.00293 (0.0460)	0.104** (0.0442)	0.151*** (0.0526)
HDI	-0.0532 (0.0474)	-0.00818 (0.0469)	-0.0223 (0.0564)	0.0415 (0.0380)	-0.0453 (0.0298)	-0.0383 (0.0332)
ECOSTAT	-0.00226** (0.0162)	0.00566 (0.0182)	-0.00293 (0.0246)	-0.0364** (0.0145)	0.0224 (0.0138)	0.00837 (0.0169)
GOVind	0.0140*** (0.00233)	-0.00194 (0.00274)	-0.000880 (0.00355)	0.0177*** (0.00225)	8.23e-06 (0.00259)	0.00158 (0.00328)
IFRSGOV	0.00066** (0.00120)	0.00271** (0.00116)	0.00250* (0.00130)			
IFRSHDI	0.201*** (0.0491)	0.244*** (0.0515)	0.289*** (0.0630)			
IFRSECO	-0.0523*** (0.0114)	-0.0541*** (0.0116)	-0.0608*** (0.0140)			
IFRSAUD	-0.00567** (0.00261)	0.00246 (0.00314)	0.000206 (0.00372)			
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Constant	0.0332 (0.0298)	-0.116*** (0.0298)	-0.138*** (0.0362)	-0.0298 (0.0236)	-0.102*** (0.0188)	-0.138*** (0.0220)

Observations ³²	19,206	19,179	19,223	19,206	19,179	19,223
R-squared	0.467	0.478	0.651	0.466	0.476	0.651

This table measures the effect of firm-level and country-level variables of discretionary accruals-based earnings management models adopted in analysing the pooled data of both developed and emerging economies using a pooled OLS. The first segment of the table presents the result of the analyses where both firm and country level variables are used with interactive variables while the second segment of the table presents the results without interactive variables. Discretionary accrual models used include the modified Jones model, the Jones model and the Performance matched model. To control for fixed effect, 2005 was used as the reference year, and utility sector was used as the reference industry. ***, **, and * signify 1%, 5% and 10% levels of significance, respectively. The t-statistics are generated through the robust function of STATA and are stated in parentheses. *IFRS* signify IFRS adoption with 1 if the firm has adopted IFRS and Zero if otherwise. ***, **, and * implies 1%, 5% and 10% levels of significance respectively. DisAcc refers to the discretionary accruals derived through modified Jones model. IFRS is a dummy variable for adoption of IFRS. It takes the value of 1 if firms have adopted IFRS and 0 if otherwise. DISSUE is the percentage change in long term debt, EISSUE is the percentage change in equity, TURNOVER is the total sales scaled by total asset employed, CFO measures the cashflow from operations, ROTA, the return on total asset, and LEV is the proportion of the total liability to total equity. GROWTH signifies firm's growth potentials and it is calculated by percentage change in Turnover. SIZE is the logarithm of total assets employed. AUD refers to audit quality. It takes the value of 1 if firm is audited by any of the big four firm and 0 if otherwise. GDP, HDI, ECOSTAT and GOVind are country-level variables, which indicate percentage growth rate of the gross domestic product, Human Development Index, Economic Status and Governance Indicator. IFRSGOV IFRSAUD IFRSECO and IFRSHDI are interactive variables (IFRS and Governance Indicator, IFRS and AUD, IFRS and ECOSTAT and IFRS and HDI) generated to test the impact of their interaction on the extent of earnings management.

Discussion of Multivariate regression Result of the Pooled OLS and Hypothesis Testing

Earnings Management Models with Interaction Variables

The first section of Table 6.3 reveals a negative association of the three EM models to the adoption of IFRS. The relationship is significant at 1% level for all models. This provides strong evidence that adoption of IFRS promotes financial reporting quality through reduced earnings management. Hence, we accept hypothesis H1 that there is a negative relationship between IFRS adoption and earnings management practices. The result is consistent with the findings of Daske and Gebhardt, (2006), Barth *et al.*, (2008); Doukakis, (2010); Houque *et al.*, (2012); Wan-Ismail *et al.*, (2013), and Horton *et al.*, (2013) who argue that adoption of IFRS enhances the quality of accounting figures and

³² Figures of observations differ in this table and others due to winsorization to correct outliers.

the disclosure quality. However, the result opposes the findings of Paananen and Lin (2009); Capkun *et al.* (2012); Ahmed *et al.* (2013) who find a reduction in the earnings quality on the adoption of the IFRS.

The association between earnings management and audit quality provides a mixed result for all the models. MJM shows an insignificant positive relationship with audit quality while other models (JM and PMM) show significant positive relationship with audit quality. This can be due to the paradigm shift in the services of the Big-Four audit firms who are more into consultancy than promoting objectivity of published financial statements. They render services according to what their contractors want. However, the interaction of IFRS and the audit quality measure by the engagement of any of the big four audit firms revealed a significant negative result at 1% level of significance, while other model showed an insignificant result. I uphold the result given by MJM because the panel data regression supports this even for all models at 1% level of significance.

The result from MJM implies that firms that reported their financial activities based on IFRS and engages one of the big four auditor are prone to have reduced level of earnings management. On this basis, H2 is accepted that there is a negative relationship between earnings management and audit quality on adoption of IFRS. This is expected as the big four audit firm has been established in the literature regarding promoting audit quality and implementation of the IFRS, promoting the quality of accounting numbers (Becker *et al.*, 1998; Park *et al.*, 1999; Riahi-Belkaoui, 2004; Yasar, 2013; Rusmin *et al.*, 2014). The corroborating inputs of the two are likely going to enhance the quality and reliability of published financial statements. Although the literature provides evidence that the big four reduces the incidence of earnings management, no publication exists on the effect of the interaction between the audit quality and IFRS adoption on the level of earnings

management. This study therefore, contributes to knowledge in this aspect.

Furthermore, the GOVind shows a positive and significant association with the MJM model of earnings management at 1% level of significance. The interaction of the IFRS and the GOVind with accrual measures of earnings management shows a positive relationship for all models at 5% for the MJM and JM while the PMM is at 10%. This is evidence that the aggregated index through PCA, government effectiveness, voice and accountability, political stability, the control of corruption, the rule of law, and regulatory quality are linked with increased level of earnings management among firms in all the economies. Increase in these scores is expected to lead to produce reduced agency costs and information asymmetry. Hence increase in the GOVind is expected to lead to reduced incidence of earnings management.

The result is consistent with the findings of Lemma *et al.* (2013) from a study 44 countries of the world that firms in countries with good governance scores have a higher tendency of involvement in accruals-based earnings management. Due to the positive relationship, we, therefore, fail to accept hypothesis H3 that there is negative relationship between the level of earnings management and adoption of IFRS by countries with good governance.

One of the core research questions that this research seeks to answer is to examine whether the IFRS can be a one size fits all for all economies. Gleaning from the regression outputs, the association of economic status to all earnings management models adopted in this study gives mixed results like some other variables of the model. However, the MJM result aligns with the result from the descriptive statistics that establish that earnings management is more prevalent with the emerging economies. The negative association between the

discretionary accruals measure of earnings management using the MJM is significant at 5% level while other models reveal positive and statistically insignificant results. Furthermore, the regression result on the interaction of IFRS and ECOSTAT with the discretionary accruals measured by all the models reveals consistent results among all the models. This implies that a higher level of earnings management is associated with the adoption of IFRS in emerging economies. This is another contribution to knowledge as no work has compared the impact of the adoption of the IFRS on financial statement quality by comparing the emerging and developed economies. This provides support for hypothesis H4 that there is negative relationship between earnings management and adoption of IFRS by countries of higher economic status.

Also, on human development, the regression result reveals a negative but statistically insignificant association with all the earnings management models. This implies that increased earnings management is associated with reduced human development among countries; though not statistically significant. However, the interaction of the association between the HDI and the IFRS with discretionary earnings management models reveals positive results for all the models. This implies that on adoption of the IFRS, the level of earnings management increases with the level of human development.

The reason for this might be the flexibility of the IFRS might have been exploited for upward earnings management due to an increase in human development, which is mostly informed by education (Riahi-Belkaoui, 2000). They are also positive and are significant at 1% level. Based on this, we fail to accept hypothesis H5 that there is a negative relationship between earnings management and human development in countries that adopt the IFRS. Also, this is another contribution to the literature as no prior study has ever investigated this.

Furthermore, it could be observed that the discretionary earnings management models reveal negative results, which are all statistically significant at 1%, level for model 1 to 3 where both country level and firm level variables are used with interaction unlike models 4 to 6 whose results are inconsistent. This further corroborates H1 that earnings management among countries is influenced by firm level and country level variables; as well as their interactions.

EM, Firm-Level and Country Level without Interactive Variables.

The second section of Table 6.3 shows the association of the three earnings management models with the independent variables without interaction variables. It shows that the association between the discretionary accrual as measured by the modified Jones model is negative. However, the relationship is not statistically significant, while other models revealed a positive association and significant results. This confirmed prior findings that mixed finding on the relationship of IFRS adoption and earnings management might be as a result of the model used in the study (Capkun *et al.*, 2016; Doukakis 2014). Hence, this does not provide enough evidence for the acceptance of hypothesis H1. Also, change in DISSUE is positively associated with the change in the earnings management measured by MJM (significant at 5% level), negatively with JM (insignificant) and negatively associated PMM (significant at 1% level).

The difference in MJM and PMM might be attributed to the profitability included in PMM the investors' sensitivity to firms' profitability and information asymmetry. The EISSUE, on the other hand, gives a relatively consistent negative result for both MJM and the standard JM. The results are insignificant, unlike the PMM, which indicates a negative associative with EISSUE (significant at 1%). This negative relationship implies that increased earnings management erodes firms' equity as unreal reported profit jeopardises the equity of the reporting

firm. The reason behind this relationship can also be as relating to DISSUE, as explained earlier. TURNOVER gives a relatively stable result for all the EM used.

Table 6.4 Firm-Specific Variable, Country-Specific Variables and Earnings Management

	EM and Firm Specific-variables			EM and Country Specific-variables		
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	DisAcc MJM	DisAccJM	DisAccPMM	DisAccMJM	DisAccPMM	DisAccJM
IFRS	-0.00947*** (0.00310)	0.00796*** (0.00277)	0.00932*** (0.00306)	-0.00793** (0.00359)	0.0134*** (0.00454)	0.0118*** (0.00322)
DISSUE	0.00702** (0.00310)	-0.00233 (0.00302)	-0.0162*** (0.00358)			
EISSUE	-2.64e-05 (0.00457)	-0.000473 (0.00494)	-0.00919 (0.00736)			
TURNOVER	-0.0156*** (0.00140)	-0.0158*** (0.00118)	-0.0169*** (0.00139)			
CFO	-0.626*** (0.0155)	-0.529*** (0.0175)	-0.515*** (0.0214)			
ROTA	0.742*** (0.0158)	0.621*** (0.0211)	1.522*** (0.0303)			
LEV	0.00101*** (0.000327)	0.00116** (0.000562)	0.00123 (0.000798)			
GROWTH	-0.0718*** (0.00538)	-0.0421*** (0.00436)	-0.0485*** (0.00502)			
SIZE	-0.00124*** (0.000354)	0.00807*** (0.000446)	0.00882*** (0.000526)			
AUD	-0.00164 (0.00145)	0.0103*** (0.00161)	0.00966*** (0.00191)			
GDP				0.00544 (0.0532)	0.257*** (0.0743)	0.109** (0.0506)
HDI				-0.0772* (0.0448)	-0.298*** (0.0512)	-0.148*** (0.0351)
ECOSTAT				-0.0550*** (0.0174)	-0.0203 (0.0236)	0.0204 (0.0164)
GOVind				0.0283*** (0.00286)	0.0159*** (0.00443)	0.00518* (0.00313)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Constant	0.0787*** (0.00653)	-0.114*** (0.00795)	-0.146*** (0.0103)	-0.0354 (0.0265)	0.170*** (0.0299)	0.0407** (0.0205)
Observations	19,206	19,179	19,223	21,163	21,162	21,162
R-squared	0.464	0.476	0.851	0.226	0.676	0.299

Earnings management and Firm-Level Variables

The modified Jones model measure of earnings management revealed a negative association, which significant at 1% level of significance with IFRS adoption. This implies that, generally, the adoption of IFRS significantly reduced the extent of earnings management among reporting firms of both emerging economies and developed economies. However, other earnings management measures: the standard Jones model and performance-matched model, showed a positive and statistically significant relationship at 1%. The difference in the result might be traceable to earnings management emanating from receivables such as bad debt provision that the modified Jones model considered.

Debt issue increased significantly with discretionary accruals measured through modified Jones model (MJM). The standard Jones model reveal a negative association but an insignificant result while the performance match model showed a negative association at 1% significant level. All the EM models depict a negative association with the EISSUE, but the associations are all statistically insignificant. This implies that earnings management among countries reduces the value of equity of reported firms.

Furthermore, the result of the association between TURNOVER and all the EM models revealed consistent and negative results at 1% level of significance. This implies that firms with reduced sales might resort into earnings management to cover up in meeting investors' and analysts' expectations. Also, for all the earnings management models, earnings management is negatively associated with cashflow form operation at 1% level of significance. On the other hand, ROTA and earnings management are positively associated with all the earnings management models. The value from PMM, as might be expected is higher those other models because of the inclusion of the return on

assets in its calculation which other models do not control for. This implies that most firms among the countries manage their earnings upward.

The discretionary accruals through the MJM is positively associated with firms' leverage at 1% level of significance while the JM though also positive but at 5% level of significance. The positive association with the PMM is insignificance. Based on the MJM and JM results, high geared firms engage in more of earnings management than low leveraged firms.

The association between growth and the level of earnings management is also found to be negative and statistically significant at 1% level for all the earnings management models used. MJM has the lowest figure. This implies that firms engaging in too much of earnings management threaten their potentials for growth. In other words, firms with great growth potentials engage in less of earnings management. The result is consistent for all the earnings management models. Size of firms shows a negative association with discretionary accrual calculated through MJM. This implies that larger firms have reduced earnings management compared to smaller firms. This might be as a result of the scrutiny that has from investors and analysts. The result is opposite to those from JM and PMM. This might be traceable to differences in the composition of the formula for calculating each model.

The association between discretionary accruals and audit quality measured by the engagement of any of the big four showed a negative but statistically insignificant result. JM and PMM showed positive association at 1% level of significance.

EM and Country Specific Variables

The focus of this section is to discuss the relationship between earnings management and country related variables alone. All the models of earnings management have a positive association with the growth rate of Gross Domestic Product (GDP). While the JM and PMM show a positive association, significant at 1% level of significance, the MJM revealed a positive but insignificant relationship. The HDI is negatively associated with the level of earnings management in all models used. However, the level of significance differs at 10%, 1% and 1% respectively for MJM, JM and PMM. This implies that the higher the level of human development in a country, the lower the tendency that managers of firms domiciled in such countries will engage in earnings management. In other words, countries that prioritise human development in their economic policy is expected to have reduced incidence of earning management, hence improved financial reporting. This is one of the methodological contributions of this study.

Regarding the ECOSTAT, the MJM reveals a negative association with it at 1% level of significance while result depicted by other models are insignificant; though JM has a negative result, the PMM has a positive result. The result from the MJM aligns with the descriptive statistics hence is upheld. The result implies that emerging economies are more identified with EM than developed economies. This might be resulting from the poor financial reporting system and political instability usually the common phenomenon of emerging economies.

The two sections of the table emphasised the essence of both firm-specific and country related variables in the evaluation of the impact of IFRS on earnings management among countries.

6.2 Developed Economies

This section evaluates 486 active firms that have published financial information for at least 21 years (the adoption year inclusive). Hence, this section starts by examining the 10,206 firm-year observations relating to firms from France, Germany, United Kingdom, Italy and Australia. This study seeks to investigate whether the adoption of IFRS promotes the quality of financial reporting or not. Although table 6.2 presents a country by country descriptive statistics of the data of sampled firms in the developed economy category, it is worthwhile to evaluate the developed economies as a whole to know whether earnings management or earnings smoothing reduced after the mandatory year of adoption of IFRS in 2005 or not. On this basis, table 6.3 tests the difference in the average level of earnings management for the two eras (Pre and Post-IFRS adoption periods).

6.2.1 Discussion on the Descriptive Statistics of Developed Countries

Panel A of Table 6.5 presents results relating to the measures of earnings management and control variables used in the study. The purpose of devising this is to assess how each country contributes to the research results. This is to give further insight into the level of earnings management before the adoption of IFRS, and after the adoption of IFRS. Pre and Post IFRS adoption period relates to the developed economies alone. This is due to the lack of uniformity in the year of adoption by the emerging economies. Nevertheless, the discrepancy in the year of adoption is controlled for in the study.

According to Table 6.5, Germany experienced a reduced level of earnings management on the average between the pre-IFRS adoption era (12.4%) and the post –IFRS adoption era (7.1%) in absolute terms; this is significant at 10% for the modified Jones model and 5% level of significance for Jones model and performance matched model. Both net income variability and Cashflow variability increased over the two eras.

This led to a significant reduction in the volatility of net income to cashflow from operations

The average extent of EM as calculated from the absolute discretionary accrual in Australia is 7.5% with a standard deviation of 10.1 for the period between 1995 and 2015. Also, there is a significant difference in the average discretionary accrual between the IFRS regime and the period of GAAPs; evidenced with reduced earnings management from all models of earnings management used. However, the variability of net income, as well as cashflow, increased at 5% and 1% level of statistical significance respectively, while the increase in the volatility of net income to cashflow over the two eras is statistically insignificant.

France also has a significant reduction in the level of earnings management over the pre and post-IFRS adoption era. The extent of earnings management among firms was averaged at 5.7%. However, net income variability increased significantly while the cashflow variability reduced significantly at 1% level of significance. Furthermore, the volatility of net income to cashflow from operation reduced over the two eras at 5% level of significance.

Although there is a significant reduction in the incidence of earnings management during the era of IFRS, the degree of earnings management practised in Italy averaged 12.1%. This is the highest of all the countries studied in this research. The net income variability and the cashflow variability is significantly higher over the two eras at 1% level of significance. The proportion of net income variability as influenced by cashflow variability though reduced, it is not statistically significant.

The United Kingdom also experienced a significant reduction in EM on the adoption of IFRS. The level of earnings management in the country averaged 6.2%. Like most other developed economies, net income variability increased significantly at 1%. However, the cashflow

variability reduced significantly into the period of IFRS adoption. The increase in the volatility of net income to cashflow from operations is statistically insignificant.

Generally, all the countries of developed economic status have reduced earnings management. Nevertheless, Italy has the highest level of earnings management at 12.1% while France has the lowest at 5.7%. The range of these extremes is 6.4%.

Table 6.5 Panel A Descriptive Statistics By Countries (Developed Economies)

Country	Variable	1995-2015				From 2006-2015(A)				From 1995-2004(B)				(B-A)
		Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Diff in Mean
GERMANY	DisAccMJM	-0.080	0.106	-0.526	0.365	-0.053	0.069	-0.292	0.214	-0.108	0.100	-0.535	0.230	-0.055* ³³
	ABSDisMJM	0.101	0.096	0.001	0.644	0.071	0.059	0.002	0.512	0.124	0.093	0.002	0.562	0.052*
	DisAccJM	-0.053	0.119	-0.656	0.295	-0.036	0.084	-0.371	0.177	-0.067	0.115	-0.545	0.204	-0.031**
	DisAccPMM	-0.058	0.141	-1.140	0.427	-0.040	0.098	-0.382	0.308	-0.075	0.125	-0.515	0.375	-0.036**
	NIVar_TA	0.003	0.065	-0.353	0.364	-0.001	0.046	-0.238	0.206	0.004	0.051	-0.232	0.242	0.005***
	CFOVar_TA	0.003	0.064	-0.297	0.268	0.000	0.054	-0.214	0.215	0.006	0.055	-0.212	0.213	0.006***
	NItoCFOvar	0.304	7.678	-32.624	32.718	0.526	10.622	-55.899	111.000	0.512	8.998	-60.167	104.594	-0.014**
	DISSUE	0.079	0.370	-0.731	2.872	0.043	0.267	-0.614	2.452	0.083	0.243	-0.409	1.627	0.040**
	EISSUE	0.091	0.341	-1.174	2.294	0.041	0.218	-0.946	1.245	0.119	0.283	-0.989	1.565	0.078*
	TURNOVER	1.229	0.719	0.059	4.247	1.134	0.617	0.002	3.778	1.287	0.684	0.067	3.766	0.154
	CFO	0.107	0.090	-0.169	0.439	0.092	0.061	-0.067	0.340	0.120	0.095	-0.084	0.431	0.028**
	ROTA	0.047	0.066	-0.270	0.351	0.046	0.055	-0.133	0.288	0.044	0.054	-0.129	0.277	-0.002***
	LEV	2.339	2.230	-3.397	14.782	1.825	1.439	0.000	11.625	2.782	2.157	0.021	12.228	0.957
	GROWTH	0.060	0.240	-0.700	1.876	0.032	0.157	-0.558	1.191	0.066	0.177	-0.495	1.205	0.033**
	SIZE	14.071	2.376	8.834	19.559	14.260	2.371	10.366	18.919	13.873	2.199	10.102	18.917	-0.388

³³ ***, ** and * indicate a significant difference from zero at 1%, 5% and 10% respectively. DisAccMJM is the discretionary accrual measured through modified Jones model, ABSDisACC, the absolute value of the discretionary accrual, DisAccJM is the Discretionary accruals calculated through Jones model, DisAccPMM is discretionary accrual calculated through performance-matched model. NIVar_TA is the net income variability scaled by the total assets, CFOVar_TA is the variability in cashflow scaled by the total assets, NItOCFOvar measure the volatility of net income variability to cashflow variability, DISSUE measures the percentage change in debt issue, EISSUE measures the percentage change in equity issued, TURNOVER is the total asset scaled by total asset employed, CFO measures Cashflow from operation. ROTA is the return on total assets, LEV measured leverage, GROWTH signifies the growth potential, SIZE is the natural logarithm of total asset, GDP measures the growth rate of the gross domestic product, HDI indicates the Human Development Index and GOVind signifies Governance Index.

	GDP	0.013	0.020	-0.055	0.041	0.012	0.027	-0.059	0.041	0.012	0.010	-0.007	0.030	0.001***
	HDI	0.888	0.038	0.474	0.926	0.915	0.007	0.903	0.926	0.864	0.016	0.840	0.892	-0.050**
	GOVind	7.547	0.218	7.156	7.820	7.499	0.216	7.224	7.903	7.655	0.291	7.156	8.073	0.155
AUSTRALIA	DisAccMJM	0.019	0.109	-0.526	0.365	0.029	0.091	-0.329	0.587	0.014	0.093	-0.385	0.441	-0.015**
	ABSDisMJM	0.075	0.101	0.001	0.644	0.077	0.090	0.001	0.671	0.064	0.079	0.001	0.567	-0.013**
	DisAccJM	-0.026	0.105	-0.656	0.295	-0.014	0.080	-0.406	0.431	-0.034	0.093	-0.417	0.407	-0.020**
	DisAccPMM	-0.006	0.170	-1.140	0.427	0.004	0.138	-0.608	0.531	-0.007	0.128	-0.553	0.692	-0.011**
	NIVar_TA	0.004	0.090	-0.353	0.364	-0.003	0.086	-0.431	0.342	0.010	0.075	-0.302	0.487	0.012**
	CFOVar_TA	0.004	0.067	-0.297	0.268	0.000	0.053	-0.281	0.130	0.008	0.058	-0.237	0.251	0.007***
	NItoCFOvar	0.134	7.114	-32.624	32.718	0.061	5.606	-32.624	37.277	0.432	5.211	-24.250	27.739	0.372
	DISSUE	0.112	0.466	-0.731	2.872	0.084	0.312	-0.645	1.887	0.101	0.464	-0.845	3.618	0.018**
	EISSUE	0.100	0.353	-1.174	2.294	0.084	0.241	-0.578	1.727	0.096	0.311	-0.732	2.693	0.011**
	TURNOVER	0.962	0.776	0.059	4.247	0.956	0.766	0.107	4.384	0.922	0.655	0.057	3.319	-0.034**
	CFO	0.090	0.073	-0.169	0.439	0.091	0.062	-0.193	0.312	0.088	0.064	-0.125	0.295	-0.003***
	ROTA	0.051	0.082	-0.270	0.351	0.051	0.066	-0.270	0.316	0.047	0.077	-0.343	0.287	-0.004***
	LEV	1.295	1.490	-2.821	14.782	1.136	0.928	0.034	7.521	1.253	0.817	0.050	7.439	0.117
	GROWTH	0.088	0.317	-0.700	1.876	0.050	0.196	-0.545	1.238	0.111	0.305	-0.648	1.687	0.061*
	SIZE	14.225	1.746	9.086	17.572	14.487	1.737	9.527	17.469	14.006	1.554	9.315	16.210	-0.482
	GDP	0.033	0.009	0.018	0.050	0.027	0.007	0.018	0.038	0.038	0.008	0.019	0.050	0.011**

	HDI	0.911	0.014	0.885	0.926	0.929	0.007	0.918	0.939	0.898	0.008	0.885	0.910	-0.031**
	GOVind	6.235	0.116	6.005	6.441	6.250	0.105	6.097	6.397	6.224	0.130	6.005	6.441	-0.026**
FRANCE	DisAcc_MJM	-0.009	0.095	-0.526	0.365	0.000	0.064	-0.427	0.206	-0.016	0.082	-0.463	0.199	-0.016**
	ABS_DisMJM	0.057	0.086	0.001	0.644	0.044	0.049	0.001	0.427	0.060	0.077	0.001	0.520	0.015**
	DisAccJM	-0.012	0.096	-0.656	0.295	-0.003	0.064	-0.429	0.202	-0.019	0.081	-0.464	0.201	-0.015**
	DisAccPMM	-0.603	0.130	-1.140	0.427	-0.597	0.098	-1.143	-0.324	-0.615	0.104	-1.172	-0.333	-0.018**
	NIVar_TA	0.004	0.058	-0.353	0.364	0.002	0.041	-0.188	0.212	0.004	0.036	-0.181	0.214	0.002***
	CFOVar_TA	0.004	0.061	-0.297	0.268	0.004	0.048	-0.198	0.209	0.004	0.049	-0.202	0.219	-0.001***
	NItoCFOvar	0.035	5.729	-32.624	32.718	0.268	3.333	-24.000	20.787	-0.167	3.878	-27.446	21.618	-0.436
	DISSUE	0.106	0.369	-0.731	2.872	0.060	0.215	-0.429	1.833	0.107	0.269	-0.443	1.822	0.046**
	EISSUE	0.094	0.330	-1.174	2.294	0.063	0.202	-0.940	1.738	0.090	0.224	-0.957	1.795	0.027**
	TURNOVER	1.077	0.584	0.059	4.247	0.980	0.465	0.203	3.630	1.128	0.502	0.181	3.733	0.148
	CFO	0.092	0.086	-0.169	0.439	0.083	0.064	-0.099	0.527	0.100	0.089	-0.097	0.555	0.018**
	ROTA	0.041	0.063	-0.270	0.351	0.040	0.053	-0.188	0.232	0.041	0.047	-0.183	0.231	-0.0001****
	LEV	2.312	2.535	-3.397	14.782	1.976	1.943	-1.187	20.620	2.535	2.539	-1.159	20.433	0.559
	GROWTH	0.082	0.240	-0.700	1.876	0.052	0.145	-0.484	1.080	0.092	0.171	-0.495	1.163	0.040**
	SIZE	13.860	2.292	8.834	19.129	14.205	2.232	9.158	18.304	13.516	2.135	9.197	18.289	-0.689
	GDP	0.016	0.014	-0.029	0.039	0.009	0.015	-0.029	0.024	0.023	0.010	0.008	0.039	0.015**
	HDI	0.866	0.020	0.825	0.897	0.885	0.007	0.873	0.897	0.848	0.011	0.825	0.862	-0.037**

	GOVind	5.497	0.245	4.852	5.824	5.484	0.310	4.852	5.824	5.487	0.155	5.172	5.774	0.003***
ITALY	DisAcc_MJM	-0.114	0.093	-0.526	0.268	-0.110	0.071	-0.637	0.055	-0.121	0.111	-1.154	0.077	-0.011***
	ABS_DisMJM	0.121	0.095	0.002	0.644	0.113	0.068	0.007	0.637	0.126	0.107	0.007	1.154	0.013**
	DisAccJM	-0.038	0.098	-0.656	0.245	-0.029	0.063	-0.412	0.199	-0.043	0.101	-1.114	0.190	-0.014**
	DisAccPMM	-0.070	0.150	-1.140	0.337	-0.065	0.099	-0.544	0.177	-0.067	0.118	-1.216	0.194	-0.002***
	NIVar_TA	0.003	0.053	-0.277	0.364	-0.001	0.045	-0.158	0.170	0.005	0.038	-0.166	0.169	0.006***
	CFOVar_TA	0.002	0.065	-0.297	0.268	0.000	0.054	-0.171	0.191	0.005	0.058	-0.205	0.213	0.005***
	NItoCFOvar	0.070	6.211	-32.624	32.718	0.258	4.960	-33.272	33.321	-0.169	4.089	-29.279	26.604	-0.426
	DISSUE	0.086	0.402	-0.731	2.872	0.049	0.274	-0.424	2.339	0.080	0.330	-0.457	2.167	0.032**
	EISSUE	0.064	0.361	-1.174	2.294	0.007	0.267	-0.751	2.518	0.078	0.264	-0.866	1.934	0.071*
	TURNOVER	0.704	0.388	0.059	3.645	0.668	0.346	0.040	1.745	0.717	0.343	0.048	1.755	0.049**
	CFO	0.078	0.089	-0.169	0.439	0.065	0.068	-0.109	0.343	0.092	0.115	-0.077	1.070	0.027**
	ROTA	0.022	0.058	-0.234	0.351	0.015	0.054	-0.143	0.155	0.027	0.046	-0.147	0.157	0.013**
	LEV	2.573	2.778	-3.397	14.782	2.639	3.021	0.079	25.639	2.544	2.698	0.068	20.164	-0.094*
	GROWTH	0.068	0.299	-0.700	1.876	0.035	0.232	-0.571	1.600	0.075	0.229	-0.573	1.681	0.040**
	SIZE	13.983	2.088	9.741	18.764	14.197	1.982	9.957	18.551	13.753	2.020	9.892	18.425	-0.445
	GDP	0.006	0.020	-0.055	0.037	-0.005	0.022	-0.055	0.020	0.017	0.010	0.002	0.037	0.021**
	HDI	0.850	0.026	0.799	0.887	0.874	0.007	0.862	0.887	0.826	0.017	0.799	0.851	-0.048**
	GOVind	3.094	0.642	2.202	4.429	2.608	0.258	2.202	3.116	3.562	0.584	2.837	4.429	0.954

UNITED KINGDOM	DisAcc_MJM	-0.024	0.088	-0.526	0.365	-0.024	0.069	-0.306	0.212	-0.024	0.073	-0.318	0.216	-0.001***
	ABS_DisMJM	0.062	0.074	0.001	0.644	0.056	0.055	0.001	0.373	0.060	0.060	0.001	0.377	0.005***
	DisAccJM	-0.150	0.147	-0.656	0.295	-0.123	0.120	-1.041	0.131	-0.177	0.156	-1.081	0.139	-0.053*
	DisAccPMM	-0.175	0.221	-1.140	0.427	-0.143	0.177	-1.425	0.206	-0.199	0.214	-1.508	0.199	-0.056*
	NIVar_TA	0.005	0.092	-0.353	0.364	0.004	0.077	-0.421	0.439	0.005	0.082	-0.408	0.436	0.002***
	CFOVar_TA	0.004	0.075	-0.297	0.268	0.005	0.065	-0.275	0.240	0.004	0.065	-0.267	0.240	-0.0001***
	NItoCFOvar	0.321	6.556	-32.624	32.718	0.242	5.038	-31.667	30.105	0.449	4.425	-31.942	30.538	0.207
	DISSUE	0.114	0.423	-0.731	2.872	0.079	0.307	-0.606	2.178	0.103	0.325	-0.609	2.339	0.024**
	EISSUE	0.083	0.413	-1.174	2.294	0.075	0.320	-1.726	2.114	0.069	0.340	-1.744	2.352	-0.006***
	TURNOVER	1.282	0.759	0.059	4.247	1.192	0.671	0.105	3.948	1.332	0.710	0.100	4.060	0.140
	CFO	0.092	0.093	-0.169	0.439	0.088	0.083	-0.215	0.362	0.096	0.085	-0.217	0.373	0.008***
	ROTA	0.056	0.095	-0.270	0.351	0.055	0.085	-0.393	0.295	0.057	0.092	-0.393	0.295	0.002***
	LEV	1.541	2.171	-3.397	14.782	1.533	1.740	-8.082	13.448	1.345	1.689	-7.894	12.036	-0.188
	GROWTH	0.080	0.271	-0.700	1.876	0.054	0.176	-0.523	1.309	0.085	0.213	-0.517	1.334	0.031**
	SIZE	12.417	2.251	8.834	19.530	12.707	2.212	8.035	18.145	12.058	2.068	7.977	18.382	-0.648
	GDP	0.021	0.017	-0.043	0.037	0.012	0.021	-0.043	0.031	0.029	0.005	0.024	0.037	0.017
	HDI	0.881	0.021	0.839	0.910	0.899	0.006	0.889	0.910	0.862	0.015	0.839	0.886	-0.037**
	GOVind	6.666	0.458	5.794	7.586	6.420	0.317	5.794	6.946	6.945	0.436	6.497	7.586	0.525

Table 6.5 Panel B reveals a statistically significant difference (reduction) in earnings management between the two eras. The perceived benefit of this on reported financial statement might have proved the mass adoption by the emerging economies. This is supported by the isomorphism theory.

Table 6.5 Panel B. Descriptive Statistics of Developed economies Before and After Adoption of IFRS										
	Pre IFRS adoption Period (1995-2004)				Post IFRS adoption Period (2006-2015)					
Variable	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Mean Diff	T-Statistic
DisAccMJM	-0.0366	0.0997	-0.3881	0.2198	-0.0219	0.0802	-0.3881	0.2198	-0.0147	-8.0184***
ABSDiscAcc	0.0756	0.0883	0.0008	0.4801	0.0603	0.0659	0.0008	0.4801	0.0153	9.6554***
DisAccJM	-0.1084	0.1613	-0.7665	0.1880	-0.0686	0.1230	-0.7665	0.1880	-0.0398	-13.683***
DisAccPMM	-0.2986	0.2951	-1.2652	0.2059	-0.2568	0.2790	-1.2652	0.2059	-0.0418	-7.1672***
NIVar_TA	0.0056	0.0790	-0.3168	0.3586	0.0024	0.0758	-0.3168	0.3586	0.0032	2.0361**
CFOVar_TA	0.0045	0.0676	-0.2427	0.2316	0.0033	0.0653	-0.2427	0.2316	0.0012	0.9199
Observation	4860				4860					

Table 6.6 Pearson Correlation Matrix and VIF Table for Developed Economies

Variables	DisAcc	IFRS	DISSUE	EISSUE	TURNOVER	CFO	ROTA	LEV	GROWTH	SIZE	AUD	GDP	HDI	GOVind	VIF
DisAcc	1														
IFRS	-0.00426**	1													1.53
DISSUE	-0.00744	-0.0305**	1												1.2
EISSUE	-0.00121	0.00270	0.0191	1											1.22
TURNOVER	0.000816	-0.0152	0.0575***	-0.0151	1										1.24
CFO	-0.0930***	0.00498	0.0268**	-0.00623	0.217***	1									1.47
ROTA	-0.0142	0.00643	0.175***	-0.0614***	0.0558***	0.0706***	1								1.79
LEV	-0.00350	-0.00486	-0.00298	-0.00265	-0.00278	0.00246	-0.0123	1							1.29
GROWTH	-0.000406	0.00420	0.227***	0.0199*	0.00187	0.000913	-0.0000634	-0.00119	1						1.35
SIZE	-0.0300**	0.133***	-0.00245	-0.00179	-0.0638***	0.0260**	0.0502***	0.0472***	-0.00925	1					1.43
AUD	-0.0130	0.00131	-0.000271	-0.00521	-0.0223*	0.0127	0.0436***	0.0131	-0.0207*	0.301***	1				1.15
GDP	0.00545	-0.385***	0.0488***	0.0185	0.00209	-0.00474	0.0335***	-0.00968	0.00495	-0.0980***	0.0516***	1			1.32
HDI	0.00519	0.625***	-0.0180	0.00511	-0.00528	-0.00131	0.00704	-0.0125	0.000209	0.136***	0.118***	-0.125***	1		3.03
GOVind	0.00790	-0.134***	0.0160	0.0203*	0.00561	-0.00418	0.0324**	-0.00893	0.00471	-0.162***	0.151***	0.303***	0.570***	1	3.08

Table 6.6 Presents the descriptive statistics of the model used in this study for measuring earnings management. The table is partitioned into four sections the mean, median standard deviation minimum and the maximum values for the developed, emerging and both Economies respectively. The third section tests the differences in means of developed country and emerging economies. The t-statistics are presented in brackets with the levels of significance indicated as ***, **, and * refer to the significance at the 1%, 5% and 10% levels of significance respectively. DisAcc refers to the discretionary accruals derived through modified Jones model. IFRS is a dummy variable for adoption of IFRS. It takes the value of 1 if firms have adopted IFRS and 0 if otherwise. DISSUE is the percentage change in long-term debt, EISSUE is the percentage change in equity, TURNOVER is the total sales scaled by total asset employed, CFO measures the cashflow from operation, ROTA, the return on total asset, and LEV is the proportion of the total liability to total equity. GROWTH signifies firm's growth potentials and it is calculated by percentage change in Turnover. SIZE is the logarithm of total assets employed. AUD refers to audit quality. It takes the value of 1 if firm is audited by any of the big four firm and 0 if otherwise. GDP, HDI and GOVind are country level variables, which indicate percentage growth rate of the gross domestic product, Human Development Index and Governance Indicator.

6.2.2 Discussion on Pearson Correlation Matrix of Developed Economies

The Pearson Correlation matrix shows that the level of earnings management measured by discretionary accruals (DisAccMJM) is negatively correlated with IFRS adoption at 5% level of significance. This result is consistent with those from descriptive statistics that earnings management reduced on adoption of IFRS among countries of developed status.

The result also depicts a negative correlation of discretionary accruals with free cashflow CFO. SIZE has a negative association with the discretionary accruals. This implies that firms larger firms are less associated with earnings management. This is because investors and analysts closely monitor them. The results are consistent with the findings of Elkalla (2017) and Doukakis (2013).

Overall, table 6.6 does not reveal any severe multicollinearity issues among the model variables. The correlation co-efficient between HDI and GOVind gives the highest figure of 0.570 which is significant at the 1% level. This does not pose any serious correlation to the models. The figure might be resulting from IFRS being a dummy variable in association with the level of human development, which in most cases increases over the years.

Further to the test of multicollinearity, the highest computed VIF as revealed from table 6.6 is 3.08. VIF of values greater than 10 are indicators of the presence of serious multicollinearity issues. Values between 5 and ten are considered to be an indicator of potential multicollinearity. Since no VIF exceeds 5 in table 6.6, it can be concluded that no multicollinearity issue is traceable to both the firm-specific variables and the country inclined variables.

Table 6.7 Multivariate Regression Results for Developed Economies						
	EM models with interaction variables			EM without interaction Variables		
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	DiscAccMJM	DisAccJM	DisAccPMM	DisAccMJM	DisAccJM	DisAccPMM
IFRS	-0.310** (0.014)	-0.219 (0.103)	-0.129 (0.445)	0.0001 (0.991)	-0.014 (0.249)	-0.008 (0.547)
DISSUE	0.004** (0.047)	-0.009** (0.015)	-0.028*** (0.000)	0.004** (0.047)	-0.009** (0.017)	-0.028*** (0.000)
EISSUE	0.001 (0.445)	-0.010** (0.018)	-0.014*** (0.002)	0.001 (0.446)	-0.010** (0.028)	-0.014*** (0.004)
TURNOVER	-0.003*** (0.001)	-0.014*** (0.000)	-0.013*** (0.000)	-0.003*** (0.001)	-0.014*** (0.000)	-0.013*** (0.000)
CFO	-0.854*** (0.000)	-0.902*** (0.000)	-0.929*** (0.000)	-0.853*** (0.000)	-0.900*** (0.000)	-0.928*** (0.000)
ROTA	0.904*** (0.000)	0.906*** (0.000)	1.918*** (0.000)	0.904*** (0.000)	0.906*** (0.000)	1.917*** (0.000)
LEV	0.000 (0.816)	0.000 (0.351)	0.001 (0.143)	0.000 (0.786)	0.000 (0.384)	0.001 (0.161)
GROWTH	-0.020*** (0.000)	-0.107*** (0.000)	-0.113*** (0.000)	-0.020*** (0.000)	-0.107*** (0.000)	-0.113*** (0.000)
SIZE	0.001*** (0.007)	0.012*** (0.000)	0.013*** (0.000)	0.001*** (0.008)	0.012*** (0.000)	0.013*** (0.000)
AUD	-0.002* (0.087)	0.034*** (0.000)	0.034*** (0.000)	-0.003*** (0.001)	0.027*** (0.000)	0.027*** (0.000)
GDP	-0.078 (0.240)	0.003 (0.972)	0.018 (0.823)	-0.060 (0.363)	0.104 (0.188)	0.119 (0.145)
HDI	0.369** (0.042)	-0.910*** (0.000)	-0.813*** (0.000)	0.413** (0.020)	-0.943*** (0.000)	-0.856*** (0.000)
GOVind	-0.007*** (0.000)	-0.019*** (0.000)	-0.022*** (0.000)	-0.006*** (0.000)	-0.014*** (0.000)	-0.016*** (0.000)
IFRSGOV	-0.002* (0.205)	0.008*** (0.000)	0.009*** (0.000)			
IFRSHDI	0.367** (0.015)	0.199 (0.217)	0.098 (0.630)			
IFRSAUD	-0.001* (0.378)	-0.013*** (0.002)	-0.013*** (0.002)			
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Country Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Constant	-0.326** (0.040)	0.740*** (0.000)	0.634*** (0.001)	-0.353** (0.025)	0.741*** (0.000)	0.640*** (0.001)
Observations	9,108	9,106	9,119	9,108	9,106	9,119
R-squared	0.775	0.660	0.922	0.775	0.658	0.922
***, ** and * signifying 1%, 5% and 10% level of significance. All variables are as earlier defined.						

6.2.3 Discussion of Multivariate Analysis

Table 6.7 presents the regression outputs of the discretionary accruals, and the platform for testing the hypothesis formulated. All the earnings management models reveal a negative association with IFRS adoption. However, only the MJM shows a statistically significant result at 5% level of significance. This provides evidence for the acceptance of the hypothesis H1 that there is a negative relationship between IFRS adoption and earnings management among firms in developed economies. The result is consistent with the pooled regression analysis done for all economies; especially the MJM. Worthy of note is that while no interaction variable exists, the opposite was the case.

Furthermore, DISSUE showed mixed results of its association with earnings management. This might be because of differences in the component of the models and how managers manipulate each of the parameters. The discretionary accruals through MJM are positively associated with DISSUE at 5% level of significance. The result is consistent with the other section of the table where discretionary there was no interaction variable in the models.

Also, the result of TURNOVER is consistent in both classifications and among the models. The negative and significant association is all at 1%. This implies that reduced turnover might be the motivation managers indulge in earnings management. The CFO also go in the same direction. ROTA is positively associated with earnings management for all models. This also implies that there is tendency that firms in developed economies manage their earnings upward. The result is also consistent with the pooled analyses earlier done.

GROWTH also shows a consistent negative result for all the EM models used. This implies that earnings management stiffens the growth potentials of any firm that engage in it. This is expected. The association is statistically significant at 1% levels with or without the

interaction variable. Also, SIZE displayed a consistent and positive association with the EM models with or without interaction variable. The association is significant, all at 1% level. This implies that larger firms practice more of earnings management than smaller firms do. This is because larger firms will always strive to meet investors' expectations and avoid surprises (Lemma *et al.*, 2013).

The quality of audit as measured by the engagement of the Big Four reveals mixed result in all the models. However, the MJM shows a negative association with the audit quality at 10% level of significance. Its interaction with the IFRS also produced a negative result for all EM models. However, MJM showed a negative association of the interaction of IFRS and AUD at 10% level of significance. The negative association from other earnings management models (JM and PMM) are significant at 1%. This provides the basis for the acceptance of hypothesis H2 that there is a negative association between earnings management and audit quality on adoption of IFRS.

Also, the HDI has a significant positive association with MJM of EM while other models produced conflicting results. Also, the interaction of IFRS with the HDI produces a significant positive result indicating that increased EM management might be traceable to an increased level of HDI. This can be interpreted to mean that dynamism of human capacity, if engaged with the flexibility that IFRS exhibit, might result in an increased incidence of earnings management. There is no evidence in the literature to support this. We, therefore, fail to accept hypothesis H5 that there is a negative relationship between earnings management and human development in countries that adopt IFRS.

The association between IFRS adoption and governance scores reveals a negative association with or without interaction among the models. This is expected of developed economies that are characterised with

good governance and political stability, unlike the emerging economies. The interaction of the IFRS and GOVind with EM revealed a negative association for all model, However, MJM is at 1% level of significance. Hence, this provides support for the acceptance of the alternative hypothesis H3 that there is a negative relationship between the levels of EM and the adoption of IFRS by countries with good governance. H4 cannot be tested when dealing with each classification but has been tested with the pooled data, which has already been done.

6.3 Emerging Economies.

This section evaluates the emerging economies, which includes China, India, Malaysia, Brazil and South Africa. While adoption of IFRS is on the wild chase by most emerging economies countries, the purpose of this research is to investigate if IFRS is a “one size fits all” standard, after all, emerging economies were not envisage when the EU member countries were devising the standard. Due to lack of uniformity in the year of adoption, the pre and post-IFRS period classification are not practicable for emerging economies. However, the literature documents it that the local standards of most emerging economies are greatly influenced since 2005, the mandatory year for IFRS adoption. This is why this study was tagged the influence of IFRS on earning management.

The country by country descriptive statistics of where sampled countries were before the advent of IFRS and their position after 2005 as far as earnings management is concerned is analysed in the table below:

Table 6.8 Descriptive Statistics of Variables of firms from Emerging Economies														
Country	Variable	1995-2015				From 2006-2015(A)				From 1995-2004(B)				(B-A)
		Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Diff in Mean
CHINA	DisAcc_MJM	0.018	0.161	-0.526	0.365	0.025	0.161	-0.728	0.572	0.019	0.149	-0.7	0.545	-0.006*** ³⁴
	ABS_DisMJM	0.124	0.128	0.001	0.644	0.127	0.126	0.002	0.922	0.116	0.12	0.002	0.936	-0.010**
	DisAccJM	0.009	0.11	-0.656	0.295	0.015	0.097	-0.34	0.321	0.01	0.089	-0.339	0.313	-0.005***
	DisAccPMM	0.045	0.156	-1.14	0.427	0.05	0.13	-0.493	0.469	0.054	0.12	-0.513	0.456	0.004***
	NIVar_TA	0.001	0.073	-0.353	0.364	0.003	0.056	-0.285	0.307	0.001	0.051	-0.275	0.306	-0.002***
	CFOVar_TA	0.003	0.083	-0.297	0.268	0.003	0.075	-0.306	0.264	0.003	0.073	-0.312	0.271	-0.0001***
	NIttoCFOvar	0.154	5.531	-32.624	32.718	0.06	3.584	-21.315	28.366	0.164	3.256	-20.111	30.246	0.105
	DISSUE	0.15	0.454	-0.731	2.872	0.12	0.334	-0.755	2.09	0.148	0.396	-0.821	2.148	0.029**
	EISSUE	0.087	0.38	-1.174	2.294	0.107	0.309	-0.986	2.31	0.052	0.273	-0.925	2.168	-0.055*
	TURNOVER	0.871	0.7	0.059	4.247	0.956	0.68	0.058	4.02	0.734	0.527	0.058	3.729	-0.221
	CFO	0.057	0.08	-0.169	0.439	0.051	0.072	-0.169	0.282	0.06	0.068	-0.164	0.282	0.008***
	ROTA	0.038	0.074	-0.27	0.351	0.036	0.066	-0.204	0.281	0.042	0.057	-0.198	0.278	0.005***
	LEV	1.547	2.051	-3.397	14.782	1.718	1.834	-1.725	14.122	1.194	1.038	-1.66	12.949	-0.524

³⁴ ***, ** and * indicate a significant difference from zero at 1%, 5% and 10% respectively. DisAccMJM is the discretionary accrual measured through modified Jones model, ABSDisACC, the absolute value of the discretionary accrual, DisAccJM is the Discretionary accruals calculated through Jones model, DisAccPMM is discretionary accrual calculated through performance-matched model. NIVar_TA is the net income variability scaled by the total assets, CFOVar_TA is the variability in cashflow scaled by the total assets, NIttoCFOvar measure the volatility of net income variability to cashflow variability, DISSUE measures the percentage change in debt issue, EISSUE measures the percentage change in equity issued, TURNOVER is the total asset scaled by total asset employed, CFO measures Cashflow from operation. ROTA is the return on total assets, LEV measured leverage, GROWTH signifies the growth potential, SIZE is the natural logarithm of total asset, GDP measures the growth rate of the gross domestic product, HDI indicates the Human Development Index and GOVind signifies Governance Index.

Table 6.8 Descriptive Statistics of Variables of firms from Emerging Economies

Country	Variable	1995-2015				From 2006-2015(A)				From 1995-2004(B)				(B-A)
		Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Diff in Mean
INDIA	GROWTH	0.128	0.367	-0.7	1.876	0.098	0.286	-0.788	1.958	0.139	0.349	-0.789	2.15	0.041**
	SIZE	15.249	1.421	10.732	19.559	15.679	1.418	12.294	19.798	14.831	1.102	12.318	19.785	-0.848
	GDP	0.093	0.017	0.069	0.127	0.094	0.024	0.069	0.142	0.092	0.01	0.077	0.109	-0.002***
	HDI	0.645	0.061	0.547	0.738	0.702	0.025	0.659	0.738	0.588	0.027	0.547	0.634	-0.113
	GOVind	-2.416	0.172	-2.649	-2.063	-2.412	0.172	-2.649	-2.083	-2.397	0.162	-2.616	-2.063	0.016**
	DisAcc_MJM	-0.019	0.088	-0.526	0.365	-0.008	0.077	-0.311	0.282	-0.03	0.067	-0.284	0.234	-0.022**
	ABS_DisMJM	0.064	0.072	0.001	0.644	0.062	0.057	0.001	0.36	0.059	0.054	0.001	0.357	-0.003***
	DisAccJM	0.017	0.084	-0.656	0.295	0.028	0.073	-0.231	0.294	0.009	0.067	-0.24	0.263	-0.019**
	DisAccPMM	0.113	0.122	-1.14	0.427	0.124	0.108	-0.239	0.524	0.107	0.094	-0.23	0.526	-0.017**
	NIVar_TA	0.004	0.069	-0.353	0.364	0.004	0.049	-0.327	0.177	0.003	0.055	-0.348	0.207	-0.001***
	CFOVar_TA	0.006	0.081	-0.297	0.268	0.007	0.072	-0.326	0.221	0.005	0.073	-0.313	0.224	-0.002***
	NItoCFOvar	0.286	4.998	-32.624	32.718	0.144	2.734	-22.622	17.223	0.4	2.689	-23.8	20.74	0.256
	DISSUE	0.156	0.434	-0.731	2.872	0.178	0.336	-0.752	2.388	0.093	0.331	-0.757	2.474	-0.085*
	EISSUE	0.125	0.347	-1.174	2.294	0.158	0.256	-0.743	1.605	0.068	0.271	-0.812	1.551	-0.090*
	TURNOVER	1.078	0.683	0.059	4.247	1.082	0.658	0.108	3.151	1.03	0.608	0.109	3.246	-0.052*
	CFO	0.098	0.092	-0.169	0.439	0.089	0.084	-0.128	0.379	0.104	0.082	-0.124	0.386	0.015**
	ROTA	0.09	0.088	-0.27	0.351	0.091	0.087	-0.103	0.402	0.086	0.076	-0.095	0.416	-0.005***
	LEV	1.825	1.96	-3.397	14.782	1.798	1.547	0.095	10.813	1.724	1.433	0.078	10.816	-0.074*
	GROWTH	0.127	0.289	-0.7	1.876	0.144	0.2	-0.693	1.324	0.086	0.252	-0.718	1.383	-0.058*
	SIZE	17.082	1.534	9.856	19.559	17.761	1.467	14.054	21.383	16.617	1.409	14.031	21.104	-1.144
	GDP	0.07	0.019	0.038	0.103	0.074	0.018	0.039	0.103	0.062	0.019	0.038	0.088	-0.012**
	HDI	0.539	0.049	0.474	0.624	0.585	0.025	0.546	0.624	0.491	0.02	0.46	0.526	-0.094*
	GOVind	-0.988	0.255	-1.49	-0.49	-1.048	0.281	-1.49	-0.714	-0.944	0.221	-1.243	-0.49	-0.104
MALAYSIA	DisAcc_MJM	-0.153	0.143	-0.526	0.365	-0.134	0.122	-0.619	0.279	-0.176	0.142	-0.724	0.253	-0.042**
	ABS_DisMJM	0.177	0.126	0.001	0.644	0.156	0.103	0.004	0.765	0.194	0.132	0.004	0.85	0.037**
	DisAccJM	-0.076	0.136	-0.656	0.295	-0.062	0.115	-0.579	0.371	-0.086	0.125	-0.612	0.365	-0.023**
	DisAccPMM	-0.12	0.21	-1.14	0.427	-0.094	0.161	-0.959	0.547	-0.137	0.196	-1.104	0.514	-0.043**
	NIVar_TA	0.003	0.088	-0.353	0.364	0.004	0.067	-0.367	0.321	0.001	0.079	-0.388	0.421	-0.003***

Table 6.8 Descriptive Statistics of Variables of firms from Emerging Economies														
Country	Variable	1995-2015				From 2006-2015(A)				From 1995-2004(B)				(B-A)
		Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Diff in Mean
	CFOVar_TA	-0.002	0.093	-0.297	0.268	-0.002	0.087	-0.341	0.342	0	0.088	-0.369	0.345	0.002***
	NItoCFOvar	-0.198	6.616	-32.624	32.718	-0.254	4.541	-35.257	29.563	-0.141	5.261	-35.75	31.214	0.113
	DISSUE	0.119	0.538	-0.731	2.872	0.091	0.508	-0.737	5.533	0.133	0.557	-0.754	4.851	0.041**
	EISSUE	0.079	0.395	-1.174	2.294	0.075	0.245	-1.016	2.116	0.065	0.372	-1.154	2.728	-0.011**
	TURNOVER	0.809	0.692	0.059	4.247	0.854	0.679	0.029	3.905	0.713	0.519	0.03	3.73	-0.141
	CFO	0.067	0.101	-0.169	0.439	0.068	0.092	-0.212	0.514	0.066	0.096	-0.193	0.537	-0.002***
	ROTA	0.039	0.091	-0.27	0.351	0.045	0.079	-0.275	0.425	0.033	0.083	-0.27	0.387	-0.012**
	LEV	1.336	2.114	-3.397	14.782	1.119	1.384	-1.361	15.106	1.394	1.78	-2.676	14.708	0.275
	GROWTH	0.105	0.411	-0.7	1.876	0.093	0.388	-0.754	4.354	0.115	0.484	-0.78	4.539	0.022**
	SIZE	13.406	1.503	8.834	18.452	13.582	1.411	10.353	17.437	13.229	1.38	10.312	17.396	-0.353
	GDP	0.052	0.037	-0.055	0.1	0.049	0.029	-0.025	0.094	0.053	0.05	-0.074	0.1	0.004***
	HDI	0.741	0.031	0.683	0.789	0.769	0.017	0.736	0.789	0.715	0.015	0.683	0.734	-0.055*
	GOVind	1.454	0.294	0.815	1.935	1.342	0.325	0.815	1.92	1.517	0.191	1.167	1.806	0.174
BRAZIL	DisAcc_MJM	-0.015	0.177	-0.526	0.365	0.038	0.153	-1.238	0.43	-0.082	0.222	-1.115	0.397	-0.12
	ABS_DisMJM	0.131	0.141	0.001	0.644	0.118	0.124	0.002	1.238	0.151	0.184	0.002	1.115	0.033**
	DisAccJM	-0.232	0.19	-0.656	0.295	-0.198	0.219	-1.689	0.252	-0.305	0.246	-1.297	0.214	-0.106
	DisAccPMM	-0.556	0.265	-1.14	0.427	-0.52	0.289	-2.1	-0.042	-0.662	0.413	-2.929	0.062	-0.142
	NIVar_TA	0.004	0.112	-0.353	0.364	0.004	0.144	-0.574	0.968	0.011	0.102	-0.469	0.451	0.007***
	CFOVar_TA	0.004	0.087	-0.297	0.268	0.004	0.1	-0.426	0.405	0.003	0.065	-0.369	0.329	-0.001***
	NItoCFOvar	-0.445	10.42	-32.624	32.718	-1.422	13.417	-156.211	17.227	-1.074	24.776	-151.755	106.831	0.348
	DISSUE	0.15	0.427	-0.731	2.872	0.139	0.318	-0.74	1.942	0.131	0.346	-0.694	1.741	-0.009***
	EISSUE	0.073	0.521	-1.174	2.294	0.06	0.84	-5.239	4.584	0.017	0.756	-10.206	2.379	-0.043**
	TURNOVER	0.956	0.634	0.059	4.247	0.911	0.589	0.031	4.427	0.936	0.506	0.082	4.415	0.025**
	CFO	0.13	0.131	-0.169	0.439	0.094	0.115	-0.184	1.226	0.194	0.199	-0.184	1.23	0.100*
	ROTA	0.026	0.112	-0.27	0.351	0.022	0.124	-0.504	0.35	0.023	0.104	-0.444	0.302	0.001***
	LEV	1.751	3.37	-3.397	14.782	1.101	5.821	-21.005	69.769	2.424	6.798	-19.034	66.742	1.323
	GROWTH	0.109	0.315	-0.7	1.876	0.076	0.252	-0.72	1.482	0.124	0.277	-0.729	1.32	0.048**
	SIZE	14.034	1.825	10.769	19.559	14.46	1.772	11.575	19.651	13.549	1.573	11.405	18.783	-0.911

Table 6.8 Descriptive Statistics of Variables of firms from Emerging Economies														
Country	Variable	1995-2015				From 2006-2015(A)				From 1995-2004(B)				(B-A)
		Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Mean	Std. Dev.	Min	Max	Diff in Mean
	GDP	0.027	0.025	-0.038	0.075	0.028	0.031	-0.038	0.075	0.026	0.017	0.003	0.058	-0.002***
	HDI	0.703	0.03	0.649	0.754	0.728	0.019	0.7	0.754	0.678	0.017	0.649	0.699	-0.050**
	GOVind	0.044	0.375	-0.619	0.794	-0.056	0.382	-0.619	0.503	0.184	0.324	-0.266	0.794	0.24
SOUTH AFRICA	DisAcc_MJM	-0.029	0.107	-0.526	0.365	-0.026	0.093	-0.367	0.442	-0.029	0.091	-0.355	0.479	-0.003***
	ABS_DisMJM	0.08	0.093	0.001	0.644	0.074	0.072	0.001	0.525	0.076	0.081	0.001	0.554	0.003***
	DisAccJM	-0.026	0.104	-0.656	0.295	-0.021	0.091	-0.355	0.425	-0.025	0.091	-0.356	0.496	-0.004***
	DisAccPMM	0.029	0.174	-1.14	0.427	0.034	0.148	-0.58	0.661	0.034	0.144	-0.503	0.74	-0.001***
	NIVar_TA	0.008	0.096	-0.353	0.364	0.008	0.086	-0.502	0.525	0.005	0.09	-0.497	0.459	-0.002***
	CFOVar_TA	0.008	0.089	-0.297	0.268	0.008	0.077	-0.299	0.271	0.009	0.086	-0.362	0.269	0.001***
	NItoCFOvar	0.282	6.054	-32.624	32.72	0.139	3.945	-27.543	28.233	0.418	4.256	-39.077	29.686	0.279
	DISSUE	0.183	0.505	-0.731	2.872	0.161	0.389	-0.753	4.749	0.178	0.503	-0.831	4.113	0.017**
	EISSUE	0.163	0.43	-1.174	2.294	0.153	0.329	-0.82	3.29	0.156	0.416	-0.872	3.211	0.003***
	TURNOVER	1.675	1.02	0.059	4.247	1.612	1.034	0.106	5.941	1.75	1.045	0.111	5.943	0.138
	CFO	0.105	0.091	-0.169	0.439	0.106	0.088	-0.148	0.345	0.103	0.076	-0.162	0.332	-0.003***
	ROTA	0.093	0.102	-0.27	0.351	0.095	0.105	-0.261	0.542	0.094	0.091	-0.253	0.553	-0.001***
	LEV	1.424	1.677	-3.397	14.782	1.342	1.205	0.069	9.039	1.335	1.153	0.065	8.371	-0.007***
	GROWTH	0.136	0.319	-0.7	1.876	0.119	0.218	-0.727	1.723	0.137	0.3	-0.767	1.945	0.018**
	SIZE	14.897	1.751	8.874	19.559	15.477	1.624	10.88	18.79	14.344	1.497	10.843	18.108	-1.134
	GDP	0.031	0.013	0.005	0.056	0.029	0.014	0.013	0.056	0.031	0.011	0.005	0.046	0.002***
	HDI	0.634	0.019	0.609	0.666	0.641	0.019	0.612	0.666	0.631	0.016	0.609	0.653	-0.010***
	GOVind	1.592	0.37	0.958	2.255	1.346	0.325	0.958	2.056	1.804	0.254	1.475	2.255	0.458

6.3.1 Discussion on the Descriptive Statistics of Emerging Economies.

Countries studied in the bracket of emerging economies include Brazil, China, India, Brazil, Malaysia and South Africa. Their descriptive statistics shown in table 6.8 are discussed in the next paragraphs.

China experienced a reduced EM as the average rate of EM (in absolute terms) before the advent of IFRS is 11.6%, which is less than 12.7% after IFRS was mandated for the EU member countries. The increased rate is significant at 1% significant level. The level of the signed discretionary accruals calculated through the MJM also increased significantly at 1% over the period. However, the PMM reveals a reduction in EM over the periods. In addition to this, on the average, the degree of earnings management among Chinese firms stands at 12.4%. There is significant increase in the net income variability and cashflow variability. The volatility of net income to cashflow variability shows a statistically insignificant reduction.

The table also reveals India as having significant increase in earnings management after 2005. This is supported by all model used, having negative and significant differences for the periods. The average level of earnings management among firms in the country is 6.4%. Variability of net income and CFOvar reduced significantly over the periods. The ratio of variability net income to variability of cashflow was, however, statistically insignificant.

Malaysia also records a significant reduction in earnings management after 2005. The extent of earnings management among her firms is averaged 17.7%. All the EM models revealed increased EM; all statistically significant at 5%. The net income variability increased significantly while variation in cashflow from operation reduced increased significantly (both at 1% level). The ratio of net income

variability to cashflow variability records a reduction of 0.113, which is not statistically significant.

Furthermore, the reduced earnings management experienced by Brazil firms after mandatory IFRS adoption is significant at 5% statistical level (in absolute terms). All the EM management models showed an increase in EM. The difference in the results might be due to the diversities in the behavioural pattern and distribution of the signed discretionary accruals. However, the absolute values of discretionary accruals controlled for this. The average level of earnings management incidence in the country is 13.1%. Variability of net income reduced significantly over the two periods, while the variability of cashflow reduced significantly over the two eras. The volatility of net income to cashflow from operation is not statistically significant.

Lastly, in South Africa, the degree of earnings management is averaged at 8%. The values of the absolute discretionary accruals are 7.4% and 7.6% respectively. The reduced level of earnings management over the two eras is significant at 1% level of significance. However, all the models of EM showed increased EM at 1% level of significance. The net income variability increased while the cashflow variability reduced at 1% level of significance. However, the volatility of net income to cashflow from operation is found to be statistically insignificant.

Generally, most of the countries, based on the result of the descriptive statistics, have reduced level of earnings management after 2005. Among the countries, Malaysia has the highest level of earnings management (17.7%) while India has the lowest (6.4%). The range of the two extremes is 11.3%. This is higher than what is obtainable in the samples of developed economies whose range is between 12.1% and 5.7% (though the same as 6.4 %.) The implication of this is that there is a greater level of earnings management among countries of emerging economic status. Hence, the question of curbing this with a uniform

standard might be like a mismatch exercise. The next sections further test this.

6.3.2 Discussion of the Pearson Correlation Matrix for Emerging Economies

Table 6.9 presents the Pearson correlation table relating to the variables of the pooled data of firms from the emerging economies from 1995 to 2015. The table is purposed to establish the existence of any multicollinearity among the fourteen variables. Although the benchmark for establishing multicollinearity in correlations ranges between 0.7 as used in Sellami and Fakhfakh (2014) and 0.8 as used in Zeghal *et al.* (2011). The highest value of the correlation between the correlated variables from the table above is 0.602. This is below all the thresholds. Furthermore, the variance inflation factor (VIF) was computed immediately after running the regression. It is presented along with the correlation matrix. The highest VIF of 2.35 is less than the threshold of 10, which indicates high levels of multicollinearity. Therefore, based on the premise above, there is no severe multicollinearity problem among the variables.

The correlation matrix in Table 6.9 reveals that the discretionary accruals (DisAcc) measuring the extent of earnings management have a positive and significant correlation with EISSUE, ROTA, SIZE, and the GDP. The 10% significant and positive association of the EISSUE and discretionary accruals implies that increased level of equity is positively associated by the increased level of earnings management practiced among firms from emerging economies. The 1% significant leve of association of the extent of earnings management to ROTA also implies that increased reported profits of firms in emerging economies are positively associated with EM. In other words, firms from emerging economies manage their profits upward. This must have led to an increase in the equity issued. This is consistent with the signalling theory. Investors and other users of financial statements often take

profitable companies as secured companies good for investments. Also, the table shows a positive and significant correlation between the level of earnings management and the GDP of the country. Also, higher earnings management is observed with firms of larger SIZE. The positive and significant relationship between DisAcc and SIZE implies that the higher the size of a company, the higher their tendency to manage their earnings to beat the expectation of users of financial statements

Conversely, the discretionary accrual correlates negatively and significantly with the IFRS, DISSUE, TURNOVER, CFO, LEV, GROWTH, AUD, HDI and GOVind, all at 1% level of significance. The negative correlation between discretionary accruals and IFRS adoption implies that adoption of IFRS reduces the level of earnings management practised by firms in emerging economies. DISSUE relates negatively with the discretionary accrual at 1% level of significance. The implication of this is that the more long-term debt capital increases with firms, the more the creditors, investor and analysts monitor such firm against earnings management.

Furthermore, firms with good volume TURNOVER are likely to be less associated with EM. The negative and significant correlation of the CFO to DisAcc means that earnings management were increasingly exercised through a reduction in CFO among firms in emerging economies. It also implies that firms with improved cashflows are less associated with earnings management in emerging economies. The negative association of discretionary accruals with LEV can be interpreted in the direction of the result DISSUE.

High-gearred firms are more monitored by investors, creditors and analysts. Hence, they may desist from earnings management. The negative and significant association of discretionary accruals with

GROWTH implies that the growth potentials of firms that engage in EM are impeded. Also, the engagement of any of the Big Four (AUD) can be deduced to have reduced the extent of earnings management. However, most companies in emerging economies cannot afford the service of the Big Four firms.

Furthermore, a negative and significant relationship between one of the country level factors, the HDI and DisAcc indicates that the higher the level of human development, the lower the extent of earnings management among firms in emerging economies. Another country level factor, the governance and political index (GOVind) having negative correlation with the DisAcc means that the increase in the quality of factors such as voice and accountability, control of corruption, the rule of law, government effectiveness, regulatory quality, and political stability have the potential of curbing the extent of earnings management among firms in the emerging economies. Consistent with institutional theory, this result negates the popular notion that emerging economies are characterised with poor governance.

Table 6.9 Pearson Correlation Matrix and VIF Table for Emerging Economies

Variables	DisAcc	IFRS	DISSUE	EISSUE	TURNOVER	CFO	ROTA	LEV	GROWTH	SIZE	AUD	GDP	HDI	GOVind	VIF
DisAcc	1														1.39
IFRS	-0.1410***	1													1.23
DISSUE	-0.0584***	0.0207*	1												1.28
EISSUE	0.0216*	0.0375***	0.239***	1											1.34
TURNOVER	-0.0489***	0.115***	0.159***	0.207***	1										1.37
CFO	-0.128***	-0.0374***	0.0598***	0.0850***	0.257***	1									1.77
ROTA	0.198***	-0.000495	0.144***	0.357***	0.350***	0.483***	1								1.15
LEV	-0.0467***	-0.00521	0.0480***	-0.123***	0.0513***	-0.118***	-0.242***	1							1.33
GROWTH	-0.119***	-0.0291**	0.402***	0.321***	0.195***	0.0211*	0.205***	0.0332***	1						1.55
SIZE	0.210***	0.0931***	0.0728***	0.0796***	0.0337***	0.103***	0.164***	0.142***	0.0626***	1					1.32
AUD	-0.113***	0.0748***	0.0331***	0.0414***	0.123***	0.119***	0.116***	-0.0236*	0.0215*	-0.095***	1				1.64
GDP	0.168***	-0.0659***	0.0201*	0.0166	-0.150***	-0.0988***	-0.0172	-0.00520	0.0804***	0.173***	-0.340***	1			1.87
HDI	-0.259***	0.368***	0.00218	-0.0242*	-0.101***	-0.112***	-0.190***	-0.0171	-0.0172	-0.438***	0.193***	-0.207***	1		2.35
GOVind	-0.358***	-0.0191	0.0172	0.0504***	0.197***	0.122***	0.104***	-0.0345***	0.00127	-0.383***	0.471***	-0.602***	0.379***	1	

Table 6.9 presents the Pearson Correlation Matrix for emerging economies. ***, **, and * implies 1%, 5% and 10% levels of significance respectively. DisAcc refers to the discretionary accruals derived through modified Jones model. IFRS is a dummy variable for adoption of IFRS. It takes the value of 1 if firms have adopted IFRS and 0 if otherwise. DISSUE is the percentage change in long term debt, EISSUE is the percentage change in equity, TURNOVER is the total sales scaled by total asset employed, CFO measures the cashflow from operation, ROTA, the return on total asset, and LEV is the proportion of the total liability to total equity. GROWTH signifies firm's growth potentials and it is calculated by percentage change in Turnover. SIZE is the logarithm of total assets employed. AUD refers to audit quality. It takes the value of 1 if firm is audited by any of the big four firm and 0 if otherwise. GDP, HDI and GOVind are country level variables which indicate percentage growth rate of the gross domestic product, Human Development Index and Governance Indicator.

Source: Author

6.3.3 Discussion of Multivariate Analysis

This section discusses the results of firms in emerging economies. The descriptive statistics have been discussed earlier. Table 5.4 presents the Pearson correlation coefficient of the variables analysed.

Table 6.10 Panel A Multivariate Regression Results of Emerging Economies						
VARIABLES	Earnings Management Models with Interaction Variables			Earnings Management Models without Interaction Variables		
	DisAcc_MJM	DisAccJM	DisAccPMM	DisAcc_MJM	DisAccJM	DisAccPMM
IFRS	-0.134***	-0.121***	-0.175***	-0.022***	0.000	-0.002
	(0.001)	(0.002)	(0.000)	(0.000)	(0.945)	(0.731)
DISSUE	-0.004	-0.001	-0.017***	-0.004	-0.001	-0.016***
	(0.423)	(0.704)	(0.000)	(0.426)	(0.732)	(0.000)
EISSUE	-0.011**	0.005	-0.010	-0.011**	0.004	-0.010
	(0.049)	(0.361)	(0.176)	(0.049)	(0.400)	(0.164)
TURNOVER	-0.027***	-0.017***	-0.021***	-0.027***	-0.017***	-0.020***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
CFO	-0.473***	-0.315***	-0.303***	-0.473***	-0.316***	-0.304***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
ROTA	0.704***	0.533***	1.391***	0.704***	0.534***	1.392***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LEV	0.002***	0.001	0.001	0.002**	0.001	0.000
	(0.009)	(0.353)	(0.517)	(0.013)	(0.454)	(0.661)
GROWTH	-0.068***	-0.015***	-0.018***	-0.068***	-0.015***	-0.018***
	(0.000)	(0.004)	(0.004)	(0.000)	(0.004)	(0.005)
SIZE	-0.005***	-0.003***	-0.003**	-0.005***	-0.003***	-0.003***
	(0.000)	(0.000)	(0.014)	(0.000)	(0.000)	(0.004)
AUD	0.005	-0.002	-0.003	0.001	-0.005*	-0.008***
	(0.123)	(0.363)	(0.392)	(0.669)	(0.053)	(0.008)
GDP	0.018	0.164***	0.224***	0.008	0.173***	0.228***
	(0.794)	(0.006)	(0.003)	(0.908)	(0.003)	(0.002)
HDI	-0.251***	-0.039	-0.138**	-0.133***	-0.035	-0.068
	(0.000)	(0.501)	(0.040)	(0.006)	(0.343)	(0.104)
GOVind	0.033***	0.008*	0.008	0.038***	0.013***	0.016***
	(0.000)	(0.083)	(0.215)	(0.000)	(0.004)	(0.009)
IFRSGOV	-0.001	0.003	0.002			
	(0.640)	(0.157)	(0.301)			
IFRSHDI	0.169***	0.183***	0.264***			
	(0.005)	(0.001)	(0.000)			
IFRSAUD	-0.013**	-0.007	-0.017***			
	(0.027)	(0.151)	(0.009)			
Year Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes	Yes	Yes
Country	Yes	Yes	Yes	Yes	Yes	Yes

Fixed Effects						
Constant	0.270***	-0.134***	-0.406***	0.202***	-0.129***	-0.440***
	(0.000)	(0.001)	(0.000)	(0.000)	(0.000)	(0.000)
Observations	10,341	10,324	10,347	10,341	10,324	10,347
R-squared	0.401	0.375	0.715	0.400	0.374	0.714

Table 6.10 Panel B Multivariate Regression Results of Emerging Economies						
VARIABLES	Firms and Country Level Variables			Country Level Variables		
	DisAcc_MJM	DisAccJM	DisAccPMM	DisAcc_MJM	DisAccJM	DisAccPMM
IFRS	-0.011***	0.005	0.004	-0.026***	-0.003	-0.005
	(0.005)	(0.173)	(0.317)	(0.000)	(0.529)	(0.434)
DISSUE	-0.004	-0.001	-0.016***			
	(0.388)	(0.722)	(0.000)			
EISSUE	-0.011*	0.005	-0.010			
	(0.051)	(0.356)	(0.184)			
TURNOVER	-0.027***	-0.017***	-0.020***			
	(0.000)	(0.000)	(0.000)			
CFO	-0.477***	-0.317***	-0.305***			
	(0.000)	(0.000)	(0.000)			
ROTA	0.714***	0.539***	1.397***			
	(0.000)	(0.000)	(0.000)			
LEV	0.002**	0.001	0.000			
	(0.017)	(0.477)	(0.700)			
GROWTH	-0.069***	-0.015***	-0.018***			
	(0.000)	(0.005)	(0.005)			
SIZE	-0.005***	-0.003***	-0.003***			
	(0.000)	(0.000)	(0.004)			
AUD	0.001	-0.005**	-0.008***			
	(0.694)	(0.049)	(0.007)			
GDP				-0.051	0.195***	0.401***
				(0.486)	(0.002)	(0.000)
HDI				-0.294***	-0.123***	-0.327***
				(0.000)	(0.003)	(0.000)
GOVind				0.060***	0.026***	0.046***
				(0.000)	(0.000)	(0.000)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	10,341	10,324	10,347	11,289	11,246	11,246
R-squared	0.397	0.373	0.713	0.229	0.255	0.490

Table 6.10 Panel A presents the OLS regression results of the pooled data of firms from China, India, Malaysia, Brazil and South Africa representing the emerging economies. The table has two sections. The first section presents the results of data with interaction variables while the second section is without the interaction variable. Panel B presents the separate regression results on firm specific and country-level variables.

The association between earnings management and IFRS shows a consistent result for MJM, JM and PMM used in the analysis with interaction in the model. The result shows a negative association for all the EM models and the association are all significant at 1% level. This implies that the reduction in earnings management among firms in emerging economies is associated with the adoption of IFRS. The second section presents results having only the discretionary accrual through MJM aligning with the first section of the table. DisAccJM and DisAcc PMM showed mixed results where no interaction variable is involved in the model. Hence, just as in the developed economies, this emphasised the essence of the interaction variables for a consistent result. This supports the acceptance of hypothesis H1 that there is a negative relationship between IFRS adoption and earnings management practices.

Apart from the PMM, all the earnings management models show negative but statistically insignificant relationship with the DISSUE. The difference might be explained by the inclusion of profitability into PM, which other models do not consider. The negative association, however, implies that earnings management reduces as debt capital increases. EISSUE shows a negative association with the discretionary accruals measured through MJM. The association is significant at 5% level. However, JM gives positive but statistically insignificant association while the PMM has a negative but statistically insignificant association with the EISSUE. Gleaning from MJM, this implies that

firms with enhanced equity are less associated with EM. A financially stable firm will be less prone to EM. Firms with low equity base will want to manage their earnings to attract investors. This is consistent with agency theory.

Regarding turnover has consistent results for the entire model, both with interaction variables and without interaction variables. The negative associations are all statistically significant at 1% level. The CFO shows the same pattern. Firms having increased turnover will be less associated with earnings management and vice versa. Also, firm with improved cashflow should be less associated with earnings management. The positive association of discretionary accruals to all models implies that firms with high profitability (ROTA) in the emerging economies manage their earnings upward. Also, the desire to achieve a higher of profitability might make managers manage their earnings upward.

The association of LEV with the entire EM models shows positive result, but only MJM showed that the relationship is statistically significant at 1%. This implies that increased level of earning management practiced by firm is associated with their financial leverage. In other words, managers of highly geared company will want to manage their earnings not to send negative signal to their creditors of inability to meet their financial obligation. This is as result of the information asymmetry.

GROWTH also shows a consistent pattern of association with the level of earnings management for all the EM models used. The association is negative and significant at 1%. This implies that firms with higher growth potentials are less associated with EM. Also, increased earnings management among firms impedes their growth potentials. The same pattern is SIZE.

The association of AUD (audit quality) with EM shows mixed results regarding the two sections of the table. However, the insignificant positive association with EM became negative and significant association with AUD interacted with the IFRS at 5% level of statistical significance. This implies that the quality of the reported statement would be more enhance where such is prepared based on the high-quality standard and where audited by one of the big four audit firms. This supports the acceptance of hypothesis 2 that there is a negative relationship between earnings management and audit quality on adoption of IFRS.

Mixed results came from the EM models regarding its association of the GDP with discretionary accruals. Though all are positive, only MJM yield a statistically insignificant result. The MJM have seen to be more reliable in analyses so far. For instance, the insignificant association of the discretionary accrual as calculated through the MJM might be traceable to the upward earnings management by firms, appearing on paper as such but not having significant effect on the economy as a whole. Furthermore, lower HDI is associated with increased earnings management among firms in emerging economies. The negative and statistically significant association is significant for MJM at 1%, insignificant for JM and significant for PMM. This means that increased earnings management among firms in the emerging economies is associated with the reduced level of human development.

However, where this interacted with the IFRS, it yielded positive and significant results in all the models. This implies that earnings management increased with human development in emerging economies on the adoption of IFRS. This does not provide support for the hypothesis H5. Hence we fail to accept that there is a negative relationship between earnings management and human development in countries that adopt IFRS.

Furthermore, GOVind showed a positive and significant relationship at 1% and 10% for all models with or without interaction variables. For the results without interaction variables, GOVind is positive and all are significant at 1% for all the models. Its interaction with IFRS gave negative but statistically insignificant result under MJM and positive results for others. This implies that earnings management reduced with countries of good governance on adoption of IFRS. However, this association is not statistically significant. Hence, we do not have sufficient evidence for accepting hypothesis H3. Therefore, we fail to accept that there is a negative relationship between the level of earnings management and adoption of IFRS by countries with good governance score.

Panel B empirically established that reliable and consistent results emerge when both firm-specific, country-inclined and interaction variables are used while establishing the effect of the international financial reporting standard on the quality of reported earning, especially in multi-country studies.

6.4 Robustness Check and Further Test for Endogeneity

This section presents the results for the panel regression for the 21,588 total firm-year observations relating to both the 486 firms in developed economies and the 542 firms in emerging economies. This is to corroborate the earlier analysed panel data.

The data of sampled companies of developed and economies were pooled together and the variables treated flexibly to establish the robustness of the study. Equation 1³⁵ tests the overall efficacy of IFRS on the magnitude of discretionary accrual. The result reveals that discretionary accrual reduces significantly on adoption of IFRS. D in analysing the pooled data from all the economies, the result aligns with

³⁵ Please see Panel below

that of the reported pooled data of both economies largely (See Appendix4). Also, the last column (Column 7) of the panel regression tests the decision to adopt IFRS at country level, using IFRS as the dependent variable in a logit regression. The result also confirms improvement of the quality of financial statement through reduced earnings management on adoption of IFRS.

On endogeneity issues, the data was reset using the xtset command of data and tested for endogeneity by comparing the random effect result with the fixed effect result and testing the difference by hausman test to know the appropriate model for the study. The test failed to accept random effect, hence fixed effect was adopted.

A more efficient and conventional method was also used to test for endogeneity, the difference GMM as used in Dayanandan, *et al.* (2016) to further control for endogeneity (see column 2 of table 6.11). The eventual GMM aligns in result with other results hence providing a better estimate.

Table 6.11 Robustness Check and Test for Endogeneity				
VARIABLES	DisAcc_Hausman_Test	DisAcc_DiffGMM	Disc_TimeFE	DisAcc_FE
IFRS	-0.157*** (0.000)	-0.046*** (0.001)	-0.190*** (0.000)	-0.190*** (0.000)
DISSUE	0.004** (0.022)	-0.015*** (0.000)	0.004** (0.016)	0.004** (0.016)
EISSUE	-0.002 (0.299)	-0.013*** (0.003)	-0.002 (0.308)	-0.002 (0.308)
TURNOVER	-0.017*** (0.000)		-0.031*** (0.000)	-0.031*** (0.000)
CFO	-0.502*** (0.000)		-0.456*** (0.000)	-0.456*** (0.000)
ROTA	0.760*** (0.000)	0.847*** (0.000)	0.785*** (0.000)	0.785*** (0.000)
LEV	0.000 (0.352)		0.000 (0.206)	0.000 (0.206)
GROWTH	-0.070*** (0.000)	-0.072*** (0.000)	-0.064*** (0.000)	-0.064*** (0.000)
SIZE	0.005*** (0.000)	0.056*** (0.000)	0.009*** (0.000)	0.009*** (0.000)
AUD	-0.008** (0.015)		-0.020 (0.713)	-0.020 (0.713)
GDP	0.128*** (0.000)		-0.004 (0.894)	-0.004 (0.894)

HDI	-0.139*** (0.000)		-0.043 (0.328)	-0.043 (0.328)
ECOSTAT			-	-
GOVind	-0.010*** (0.000)		0.013*** (0.000)	0.013*** (0.000)
IFRSGOV	-0.001 (0.442)		-0.001 (0.265)	-0.001 (0.265)
IFRSHDI	0.267*** (0.000)		0.269*** (0.000)	0.269*** (0.000)
IFRSECO	-0.066*** (0.000)		-0.055*** (0.000)	-0.055*** (0.000)
IFRSAUD	-0.012*** (0.000)		-0.008*** (0.003)	-0.008*** (0.003)
ECOSTAT	0.141*** (0.000)			
L.DisAcc_MJM		0.159*** (0.000)		
Constant	-0.015 (0.341)	-0.848*** (0.000)	-0.113** (0.013)	-0.113** (0.013)
Observations	19,206	18,660	19,206	19,206
R-squared			0.275	0.275
Number of FirmID	1,027	1,028	1,027	1,027

pval in parentheses *** p<0.01, ** p<0.05, and * p<0.1 signify statistical significance at 1%, 5% and 10% respectively.

Due to differences in the year of adoption of IFRS in the emerging economies, this study conducted testparm test in STATA. The result the necessity of controlling for time fixed effect. This was incorporated in third column of Table 6.11. The result is also consistent with other reported results.

To control for further variables that cannot be observed or measured, such as cultural differences, business practices across the companies, changes over the year regarding countries' policy regulations and agreement with international bodies, this section adopts the panel data so that individual heterogeneity can be accounted for. Therefore, in this analysis, the panel data controls for the year fixed effect, industry fixed effect and country fixed effect. This is the same procedure used in analysing the emerging economies data and the developed economies data. As a robustness check, this section uses different methods of

controlling for the individual heterogeneity in the data: fixed effect and the random effect.

Analysing the data in STATA demands that the data be reset using the *xtset* command. This gives a result indicating that the data is strongly balanced with time variable being year 1995 to 2015 and a *delta* value of 1 unit. When the data was controlled for fixed effect, it gives *f*-value as <0.05 . This makes the causes of changes across the entities to be explored. To decide the appropriate effect for the study (fixed or random), the Hausman Test was run. The test indicates that the fixed effect is appropriate for this study. The Prob $>$ Chi2 value gives 0.000, which is less than 0.05.

Also, the Breusch and Pagan Lagrangian Multiplier test for random effect were run to establish further whether there are significant differences across units analysed. The results of Prob $>$ Chi2 came as 0.000. This shows significant differences across the countries.

Also, the results of earnings smoothing measures, such as Variability of Net Income, Variability of Cashflow from operation, proportion of the variability of Net Income to Cashflow, and tendency of managing earnings towards small positive income in table 6.12 are mostly in harmony within the interpretation of the results from earnings management measures earlier discussed earlier.

Table 6.12 Earnings Smoothing Measures				
	(1)	(3)	(4)	(5)
VARIABLES	NIVar TA	CFOVar TA*	NItoCFOvar TA	SPOS
IFRS	0.008*	0.010	-0.991*	1.404
	(0.055)	(0.165)	(0.090)	(0.220)
DISSUE	-0.032***	-0.012***	-0.027	-0.312
	(0.000)	(0.000)	(0.886)	(0.160)
EISSUE	0.025***	0.000	0.295	0.602***
	(0.000)	(0.935)	(0.249)	(0.000)
TURNOVER	-0.002*	-0.001	-0.245**	-0.077
	(0.062)	(0.534)	(0.012)	(0.433)
CFO	-0.112***			
	(0.000)			
ROTA	0.451***	0.091***	-0.525	-8.982***
	(0.000)	(0.000)	(0.594)	(0.000)
LEV	0.003***	0.001***	-0.008	0.128***
	(0.000)	(0.006)	(0.766)	(0.000)
GROWTH	0.037***	0.056***	0.402	0.387
	(0.000)	(0.000)	(0.275)	(0.189)
SIZE	-0.002***	-0.000	-0.039	0.041
	(0.000)	(0.134)	(0.234)	(0.117)
AUD	0.000	-0.000	-0.015	-0.356***
	(0.784)	(0.943)	(0.908)	(0.003)
GDP	0.065	-0.178***	3.065	-6.678
	(0.246)	(0.007)	(0.672)	(0.188)
HDI	0.112	0.286*	-18.321	-2.992
	(0.369)	(0.075)	(0.415)	(0.826)
GOVind	-0.002	-0.000	0.063	0.018
	(0.360)	(0.947)	(0.794)	(0.913)
Year Fixed Effect	Yes	Yes	Yes	Yes
Industry Fixed Effect	Yes	Yes	Yes	Yes
Country Fixed Effect	Yes	Yes	Yes	Yes
Constant	-0.078	-0.250*	15.846	-0.461
	(0.488)	(0.084)	(0.437)	(0.970)
Observations	9,088	9,144	9,071	9,240
R-squared	0.260	0.055	0.005	

For instance, increase the variability of net income is an indication that reported earning is not significantly managed. The result showed that on the adoption of IFRS, the variability of earnings increased at 10% level of significance. Below in table 6.13 is the summary table of hypotheses tested.

Table 6.13 Summary of Hypotheses Tested

No	All Economies	Developed Economies	Emerging economies
H1	Accept	Accept	Accept
H2	Accept	Accept	Accept
H3	Reject	Accept	Reject
H4	Accept	N/A	N/A
H5	Reject	Reject	Reject

6.5 Summary

This chapter conducted several analyses on the impact of IFRS on earnings quality. A flexible approach was adopted in analysing data; to know the reason for mixed results in prior studies regarding the impact of IFRS adoption on earnings management and to ensure that hypotheses are reliably tested. Although the emerging economies have no uniform date for the adoption of the IFRS, this was controlled for, to ensure that the results are not biased. For all the economies, there is a statistically significant improvement in earnings quality on the adoption of IFRS. However, the effect is more felt by emerging economies. This is because the IAS which later metamorphosed into IFRS is more established in the developed economy than among emerging economies whose financial reporting system is more influenced by their local GAAPs. Modified Jones model gives a more reliable and consistent result in all the analyses.

Chapter Seven: Summary, Conclusion, Limitations of the Study and Recommendations

7.0 Introduction

This chapter presents a summary of as well as the conclusion of this thesis. The chapter also explores the limitations of the study. Recommendations and areas for further research as far as earnings management and IFRS adoption are concerned will also be examined. Section 7.1 provides a summary of the thesis and discusses the main result of the analyses. Section 7.2 presents the conclusion of the results in line with the hypotheses tested. Section 7.3 explores the limitations of the research, while the last section highlights areas for future research.

7.1 Summary of the Core Research Findings

Earnings management has been a central academic debate due to the impact that it has on published financial statements and the tendency that investors might make a wrong decision while relying on it. Gleaning from the literature, incentives for earnings management range from having more remuneration especially where managers are compensated based on firms' profitability or the value of equity to avoiding the consequences of not meeting debt obligations. Also, managers practise earnings management to dodge running into government or regulatory interference. Further, managers undertake earnings management to influence stock prices, especially when they are planning to raise funds from the capital markets. This is to make the shares attractive to investors and for the shares to be highly priced.

This research is of particular interest in this era of IFRS adoption. While earnings management mars the quality and reliability of financial statements, IFRS has also been adjudged a high-quality standard that enhances the quality of published annual reports. Given the recent

popularity of the standards among countries, especially emerging economies, this study investigates the nexus between earnings management and IFRS adoption as far as earnings quality is concerned. Although many studies have been conducted on the impact of the adoption of IFRS on earnings management, this research adopts a comparative approach to investigate the phenomenon between selected developed economies and emerging economies. Findings from this provide the answer to the core question: can the adoption of IFRS be a one size fits all standard? In other words, given the potency of globalisation and diversity in the institutional frameworks of countries, it is worth knowing whether the quality of financial reporting improve among countries on adoption of IFRS or not. Also, the experience of the efficacy of the standard among countries in line with their economic classification could be evaluated.

Furthermore, this research argues that investors, academics, government and other regulators should view IFRS as a means to an end and not an end in itself. Prior studies took less cognisance of this, hence their inconsistent findings. This research agitates that, consistent with institutional theory, IFRS can be viewed as a 'good seed'. Its harvest is dependent on the economic and governance infrastructure of the country of adoption. Therefore, building on the work of Ball (2016), this research quantitatively examines how firms' characteristics, economic, regulatory and governance features can influence the effectiveness of the IFRS in enhancing the quality of reported earnings and a country's decision to adopt the IFRS. This research bridges the gap in the literature by incorporating the effect of economic, political, and regulatory system diversities among countries in analysing the impact of the adoption of IFRS on earnings management.

The research is approached by analysing the data of firms from leading countries, both developed countries and emerging economies. Firms from the United Kingdom, Germany, France, Italy and Australia,

contribute to the sample for developed countries while firms from South Africa, Brazil, India, China and Malaysia contribute to in the sample for emerging economies. The measure of earnings management used in this study is discretionary accruals in the versions of the modified Jones model, Jones model and Kothari Model.

The justification for using these three models is to see how the result from other models of earnings management could corroborate the modified Jones model. However, given popularity in the literature and its consistency in the cross-country study like this, I placed reliance on the MJM of earnings management so that the results could be gauged against prior studies. Other measures of earning quality used in this thesis include absolute discretionary accrual, variability in net income, variability in net income towards small positive income, the variability of cash flow from operation and the proportion of the variability of net income to the variability of cash flow from operation.

This thesis controls for multicollinearity by conducting the Pearson Correlation Matrix and Variance Inflation Factors for each empirical model. The results reveal no presence of significant multicollinearity issues among the variables of the model. Potential multicollinearity issues emanating from country related variables were unravelled using two methods: aggregating the six governance indicators (voice and accountability, government effectiveness, political stability, rule of law, control of corruption and regulatory quality) into a single index using the principal component analysis and using the level variables where two techniques are used. Apart from pooling all data relating to all the economies together and regressing using OLS, this thesis also devises a panel study for each economic classification to robustly corroborate research results earlier derived from developed and emerging economies and to provide the answer to the research questions. The robust feature of STATA was used to generate the Huber White standard error to control for heteroscedasticity.

Generally, the cross-sectional fixed effect regression results revealed that the adoption of IFRS significantly reduced earnings management, at 1% level of significance. This supports the acceptance of hypothesis H1. Earnings management model was also found to increase with the debt issue at 5% level of significance. Further, ROTA also has a positive association with earnings management at 1% level of significance. This implies that managers often manage earnings upwards to present their firms as capable of meeting debt covenants.

In addition to this, firms that have been publishing increasing profits might resort into earnings management when challenged with reduced profitability to meet the expectations of the public. The significant negative association of discretionary accruals with EISSUE was found not significant. The higher the equity base of a firm, the lower their tendency towards earnings management should be. This is consistent with the significant association of earnings management with profitability. Drawing on signalling theory, higher profits send a signal to investors about the viability of the company. Most investors care less about the genuineness of the reported profit. This also the case where managers are remunerated based on the level of profits.

The findings from this research also indicate that earnings management limits organisational growth. This is revealed in the negative and 1% significant association between discretionary accruals and potential for growth. Further, larger firms (size) are found to have a higher tendency for managing earnings. This is because investors, shareholders and analysts closely monitor their performances. Hence, they will want to avoid reporting surprising earnings against the expectations of their stakeholders. GDP significantly increases with earnings management. This might be because of the significant increase in economic activities through the profitability of firms and increased capital market activities (EISSUE and DISSUE).

Further, considering the interaction variables, the research findings also reveal that firms in countries that have adopted IFRS and are characterised by high human development have a strong tendency to practise earnings management. This implies that the flexibility of the IFRS in conjunction with human development and expertise will provide the avenue for increased earnings management. Also, on the adoption of IFRS, earnings management is higher for emerging economies than for developed economies. The Big Four firms are found to play significant roles in the adoption of IFRS and in reducing earnings management incidence. This supports the acceptance of hypothesis H2

Against expectation, from the pooled data of both economies, the research found that the association of governance indicator with earnings management is positive and significant at 1% of significance. The reason might not be far from the fact that IFRS is designed for are mostly used by private companies while governance is entirely the Government's issue. This implies that government of each country should not limit the administration of financial reporting activities of their countries to mandating implementation of IFRS alone, they should also work in harmony with professional bodies, accounting standard issuing authorities and other stakeholders to have a good grip of reporting quality of each firm.

The result of developed economies in comparison with emerging economies shows that IFRS is more effective in a country where there is good control of corruption, the rule of law, government effectiveness, regulatory quality, political stability and voice and accountability. Therefore, evaluating the impact of IFRS adoption on earnings quality without considering the institutional framework that makes it work better will lead to misleading inferences. This is consistent with contingency and institutional theory.

7.2 Conclusion

This study examines whether adoption of the IFRS could reduce earnings management or otherwise. The research findings in the literature regarding the topic are mixed and inconclusive (Capkun *et al.*, 2012; Doukakis, 2014). This might be because of a limited number of years studied in the literature (e.g. Zeghal *et al.*, 2011, Jeanjean and Stolowy, 2008) or peculiar economic features of the countries studied or methodology adopted. Most research done in the field is on developed economies; thus few works exist on emerging economies (Capkun *et al.*, 2012; Ahmed *et al.*, 2010 and Barth *et al.*, 2008). This research considers these limitations. Years of the study was extended and emphasis placed on the tendency that the efficacy of IFRS/IAS on financial reporting quality represented by reduced earnings management being influenced by, among others, the economic status of a country. This thesis examined a longer period to make the research historical and enhance its robustness.

This research also uses a comparative approach. This is to verify the mixed results obtained by earlier researchers which might have been due to too few countries studied, limited period of study, demographical factors and economic status of the countries studied (Capkun *et al.*, 2012; Ahmed *et al.*, 2010 and Barth *et al.*, 2008). It also evaluates how the uniform accounting standard (IFRS) can promote the quality of accounting earnings (with a special focus on earnings management) among countries with consideration to the diversity in their stages of development.

Given that earnings management is a general phenomenon just as the adoption of IFRS is now becoming a global issue. The findings from this study indicate that measuring financial reporting quality on the platform of the efficacy of the standard from which it is prepared

without due consideration of the prevailing economic conditions on which this thrives can be misleading.

This thesis examines the influence of the adoption of the IFRS on earnings management among selected countries classified into two economic classifications: developed and emerging economies. Data relating to 21, 588 observations of 1,028 firms were analysed using a series of model specifications and econometric techniques. Having discovered that a theory cannot singularly explain firms' levels of earnings management among many countries of diverse institutional features, many theories are used in this thesis for better insights.

Numerous inferences can be drawn from the results of this study. Based on firms' characteristics and country related variables used in the regression of the pooled data, the nexus between discretionary accruals and adoption of the IFRS is negative and statistically significant, the year of adoption of the standard notwithstanding. However, from the results of developed economies, when the governance and regulatory system interacted with the adoption, the result displayed a reduction in discretionary accruals at 10% significance. The equivalent result from emerging economies has a positive and significant association. The implication of this result is that the adoption of IFRS improves the quality of financial reporting better when the enforcement system is strong. The result revealed that it is not all about the IFRS standard but more about the strength of governance and enforcement systems of the adopting countries. This result is consistent with Barth *et al.* (2008) and Kvaal and Nobes (2012). Hence, the first research objective is achieved on this note.

Considering the influence of the adoption of IFRS and earnings management on the ability of firms to raise funds in capital markets, for all modifications of the discretionary accruals model in the pooled data, the association with EISSUE and DISSUE is statistically significant at

1%. The result implies that managers often managed earnings to influence the value of share prices and the chance of obtaining long-term funds from capital markets. This aligns with the behavioural theory. The result is also consistent with the target of manipulation, the ROTA, which rises significantly with earnings management. This means that the earnings are managed upward to meet investors' and analysts' expectations.

Although adoption of IFRS displayed a negative association with DISSUE and positive association with EISSUE and ROTA, these associations are not statistically significant. Also, the literature provides mixed evidence on the influence of the company's size on the quality of reported earnings. In line with the political cost hypothesis, larger firms are prone to practising earnings management downwards to circumvent excessive government control, especially when they are announcing increased profits (Zeghal *et al.*, 2011; Watts and Zimmerman, 1990; Othman and Zéghal, 2006). Conversely, company size might serve as a pointer to the essential nature of the internal control systems of firms (DeFond and Jiambalvo, 1994). Some authors found that the size of firms is positively related to firms' financial statement reliability (Bédard *et al.*, 2004; McMullen, 1996). Corroborating this, Bozec, 2008 found that the larger the size of a firm, the better the quality of their financial statements. Hence, on this premise, the second research objective was achieved.

Further, the panel regression revealed that firms' size displayed a statistically significant negative association with accrual-based earnings management. This indicates that larger firms find it challenging to manage earnings through discretionary accruals as the Big Four firms usually audit them. They are also closely monitored by the analysts and would be careful of trading their goodwill for peanuts.

There is a significant negative association between growth potential and discretionary accruals earnings management. This indicates that the low growth firms are likely to manage their earnings in order to have better prospects of raising funds from capital markets and at a reduced cost of capital. Also, they are less monitored by analysts than the high growth firms (Gaio, 2010; Lemma *et al.*, 2013).

The logit regression establishes that the adoption of IFRS influences the growth potential of a firm negatively. The statistically significant relationship implies that the adoption of the IFRS is more embraced by firms with low growth potential. Also, the significant negative association of the asset turnover with the level of earnings management indicate that firms' turnover, scaled by total assets, reduces with earnings management. This implies that earnings management dilutes firms' efficiency of the use of their assets in generating real income.

The reduced cash flow from operations was found to be significantly associated with increased earnings management. Since earnings management is a declaration of increased false profits, the cash available is a real substance that can question the reality of the reported profits. This implies that the adoption of IFRS comes with high implementation costs (such as training costs, engagement of experts and accounting system reconfiguration) that have a significant influence on the cash flow of firms.

Contrary to expectation, the result from the pooled OLS reveals strong evidence that engagement of any of the Big Four firms encourages more of earnings management by sampled firms. However, further analyses revealed that the Big Four audit firms reduce the extent of earnings management practiced in developed country while opposite is the case for emerging economies but not statistically founded. However, the result from emerging economies shows statistically significant reduced earnings management at the interaction of the Big Four and IFRS

adoption. This implies that the combined effect of engagement of the Big Four with adoption of IFRS reduces earnings management significantly. We, therefore, accept hypothesis H2. Also, the gearing level of firms is found to have strongly influenced the level of earnings management among sampled countries. Likewise, there is strong evidence that the adoption of IFRS reduces the leverage of reporting firms. This paragraph supports the achievement of research objective four.

The country inclined variables such as GOVind, GDP, HDI, and ECOSTAT impact the research result in various ways. The governance indicator index is significantly and positively related to both earnings management and the adoption of IFRS in all parameters. This implies that increased levels of earnings management demand increases in the level of governance indicators such as government effectiveness, political stability, control of corruption, voice and accountability and regulatory quality. Against expectation, the result shows a significant positive result when governance indicator index interacted with IFRS adoption. However, it is consistent with the findings of Lemma *et al.* (2013) and Elkalla (2017). This might be attributed to the fact that earnings management and governance are both behavioural exhibitions of human phenomenon. Laws made can be circumvented by managers especially on adoption of the principle based standard-IFRS. Regarding enforcement, Governments of countries will need to work with organisations at the grassroots' level to achieve desired result.

According to the pooled OLS results, the level of human development shows a negative but not statistically significant association with earnings management. IFRS adoption, on the other hand is strongly associated with reduced human development index. However, when it interacted with discretionary accruals, a positive and significant association was found. Therefore, the result does not provide support for hypothesis H5.

The general implication of economic status on earnings management is depicted in the significant and negative association between earnings management and the ECOSTAT. This implies emerging economies have higher level of earnings management than the developed economies. The same relationship is sustained when IFRS interacted with the ECOSTAT. This implies that despite adoption of IFRS, emerging economies still have higher level of earnings management than the developed economies. This indicates that the application of the IFRS suits developed countries better than emerging economies. Emerging economies should consider adapting the standard to the economic and political setting of their jurisdiction rather than implementing wholesale adoption.

Furthermore, this research acknowledges that earnings management is universal and that investors need financial statements that are prepared based on a uniform standard to enhance uniformity and informed decisions. However, the research establishes that IFRS cannot meet the reporting needs of all countries equally as far as the quality of reported accounting figures is concerned. Therefore countries, especially emerging economies, just as China has done, should consider adapting the standard to the setting of their countries, rather than mere adoption. This is consistent with contingent and institutional theory.

This study has some implications for standard setters, governments, managers and decisions makers, investors and researchers. First, the findings from this study demonstrate the extent to which both the institutional and environmental governance structures of a firm can influence the level of earnings management. This is demonstrated in the financing decisions of the managers on the volume of debt or equity to be raised, and decisions that affect the gearing of the firm. Such decisions are often made within the confinement of the prevailing accounting standards but in most cases are efforts to increase earnings management. Therefore, decision makers of organisations should be

conscious of their decisions regarding the firms' characteristics. Further, this study empirically establishes the influence of human development on the level of earnings management, especially on adoption of the IFRS.

The study also empirically documents the evidence that governments and policymakers of countries could impact on the degree of earnings management among firms by modifying their policies around industrial regulation and governance systems. Therefore, the quality of reported financial statements is a function of the quality of the standard from which it is produced, the decisions of the managers influencing the preparation and the strength of the quality governance of the country in which the firms are domiciled.

7.3 Limitations of the Study

This thesis, like much other research, has some limitations. Some countries like Australia and Brazil have lower firm-year observations due to the number of years in the study horizon adopted. Furthermore, apart from South Africa, that adopts IFRS at the time the EU made it mandatory among its firms, other emerging economies have inconsistent years of IFRS adoption. In addition, too few companies in India report their financial statements based on IFRS. Nevertheless, in line with the research objectives, this was well controlled for in the study.

Data relating to world governance indicators started from 2006 and has some missing data. Therefore, the actual picture of each country's measure of political stability, government effectiveness, voice and accountability, regulatory quality, the rule of law, and control of corruption for those missing years concerning the magnitude of earnings management behaviour could not be established but were estimated through interpolation. Furthermore, the variables suffer autocorrelation when used separately. However, they are aggregated

into a single index called Principal Component Factors (PCF) through Principal Component Analysis.

Although the literature demonstrates how corporate governance can influence the degree of earnings management among countries, this study focuses only on the engagement of the Big Four. The data relating to the Big Four was painstakingly sourced from Mergent Online. Data relating to other corporate governance indices are not available for most of the emerging economies, even from Datastream.

Further, this thesis might suffer from omitted variables. Also, diversities in findings might be provoked by different variable specifications. Finally, no causality test was conducted in this thesis. However, evidence of associations among variable is documented.

7.4 Recommendations for Future Research

The literature documents the impact of globalisation on IFRS adoption, but there is a lack of consensus on how it could be empirically measured. Given the increasing trend to IFRS adoption among countries of the world, it would be informative to study how globalisation has contributed to the speed of adoption of IFRS and the extent to which that has influenced the level of earnings management among reporting firms.

Second, aside from other country-level variables discussed in this study, recent studies have also emphasised how cultural dimensions of countries can influence the degree of earnings management (He *et al.*, 2017; Lemma *et al.*, 2013). There is a dearth of reliable data to measure the cultural dimensions of the ten countries studied. Therefore, this study excludes culture from the country-inclined variables used. Subject to the availability of data, research in the direction of the role of culture in earnings management practice among countries would be a great addition to the literature on earnings management studies.

Third, future research could go beyond establishing associations between and among variables and include causality tests to detect causality. This will bring further inference to theories and justifications for argument regarding the associations.

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Appendices 1

1. List of Dependent and Independent Variables of Earnings Management

Independent Variables used in Measuring Accrual-Based Earnings Management in this Study

Variable class	Variable	Measure	Source of Data/ Author	Expected Sign
Firm-Specific	IFRS	This assumes a dummy variable 0 for the pre-adoption period (1995-2004) and 1 for the adoption period (2005-2015).	As used in Cai <i>et al.</i> , (2008), Rudra and Bhattacharjee (2012), Sang-Kyu and Jing(2012), and Lemma <i>et al.</i> , (2013)	-
	GROWTH:	Annual percentage change in Turnover	As used in Summers and Sweeney (1998), Chen <i>et al.</i> , (2010), Ipino and Parbonetti (2011) and Sellami and Fakhfakh (2014).	+
	TURN: Turnover	The ratio of sales to Total asset	As used in Barth <i>et al.</i> , (2008) and Sun <i>et al.</i> , (2011)	+

EISSUE: Equity Issue	Annual percentage change in Equity	As used in Chen <i>et al.</i> (2010), Sun <i>et al.</i> (2011) and Zeghal <i>et al.</i> (2012)	+/-
LEV: Leverage	The proportion of long-term debt to total equity	As used in Chen <i>et al.</i> , (2010), Defond and Jambalvo (1994), Kim <i>et al.</i> (2012) and Lee <i>et al.</i> (2013)	+
DISSUE: Debt issue	Percentage change in total liability	As used in Chen <i>et al.</i> 2010, Sun <i>et al.</i> 2011).	+/-
CFO: Cash flow from operation	Cash flow from operation lagged by total asset at the beginning of the year.	As used in Sun <i>et al.</i> (2011), Zeghal <i>et al.</i> , (2012) and Doukakis (2014)	+
SIZE: Size of firm	Natural logarithm of total assets	As used in Watts and Zimmerman (1987), Chen and Liu (2010), Lemma <i>et al.</i> , (2013)	+/-
AUDIT: Audit quality	Dummy variable: 1 if the company is audited by any of the Big Four companies, 0 if otherwise	This measure was also used by Chi <i>et al.</i> (2011) and Ipino and Parbonetti (2011) for the case of real earnings management and Becker <i>et al.</i> (1998), Francis <i>et al.</i> (1999), Krishnan (2003), Zeghal <i>et al.</i> (2011) in the case of accruals earnings management.	-

	ROTA: Return on Total Assets	Net Income/ employed	Total asset	As used in Sun and Rath (2009), Zhu <i>et al.</i> (2015), Ho <i>et al.</i> (2015), Kuo <i>et al.</i> (2014), Swai (2016)	+
	GDP: Gross Domestic Product	Annual GDP growth rate		As used in Cohen and Zarowin (2008), Beuselinck <i>et al.</i> , (2014), and Chen <i>et al.</i> (2015).	+
	HDI: Human Development Index	Human Development Index		As used in Outa (2011), UNDP website	+/-
Country- Inclined	GOVind	Governance Index. Computed using principal component analysis to get an aggregate score for effective governance, rule of law, control of corruption, voice and accountability, political stability and regulatory quality indices sourced from World Bank's website.		As used in Kirch <i>et al.</i> (2009), Lemma <i>et al.</i> (2013)	+

ECOSTAT
(Economic
Status)

Dummy Variable: 1 if the
company is domiciled in a
developed economy, 0 if in an
emerging economy

Author's computation

+/-

Appendix 2: Factor Analyses

KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.606
Bartlett's Test of Sphericity	Approx. Chi-Square	54.380
	Df	15
	Sig.	.000

Communalities

	Initial	Extraction
Voice and Accountability	1.000	.818
Political Stability	1.000	.708
Government Effectiveness	1.000	.876
Regulatory Quality	1.000	.505
Rule of Law	1.000	.783
Control of Corruption	1.000	.727

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component	
	1	2
Voice and Accountability	.904	
Government Effectiveness	-.852	.387
Political Stability	.828	
Regulatory Quality	-.560	-.437
Rule of Law	-.469	.750
Control of Corruption	.485	.702

Extraction Method: Principal Component Analysis.

a. 2 components extracted.

Rotated Component Matrix^a

	Component	
	1	2
Government Effectiveness	.890	
Rule of Law	.853	
Voice and Accountability	-.688	.587
Control of Corruption		.845
Regulatory Quality		-.700
Political Stability	-.509	.670

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.^a

a. Rotation converged in 3 iterations.

Component Transformation Matrix

Component	1	2
1	-.738	.675
2	.675	.738

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.

Factor Analysis

KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.451
Bartlett's Test of Sphericity	Approx. Chi-Square	31.375
	Df	15
	Sig.	.008

Communalities

	Initial	Extraction
Voice and Accountability	1.000	.871
Political Stability	1.000	.624
Government Effectiveness	1.000	.702
Regulatory Quality	1.000	.744
Rule of Law	1.000	.871
Control of Corruption	1.000	.856

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component		
	1	2	3
Control of Corruption	.917		
Rule of Law	.903		
Political Stability	.552	-.401	.398
Government Effectiveness		.761	
Voice and Accountability		.716	-.574

Regulatory Quality		.536	.671
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Extraction Method: Principal Component Analysis.

a. 3 components extracted.

Rotated Component Matrix^a

	Component		
	1	2	3
Control of Corruption	.923		
Rule of Law	.915		
Regulatory Quality		.854	
Government Effectiveness		.764	.330
Voice and Accountability			.912
Political Stability	.554		-.559

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.^a

a. Rotation converged in 5 iterations.

Component Transformation Matrix

Component	1	2	3
1	.989	.149	.011
2	-.116	.713	.692
3	-.095	.685	-.722

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.

Factor Analysis

KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.528
Bartlett's Test of Sphericity	Approx. Chi-Square	36.275
	Df	15
	Sig.	.002

Communalities

	Initial	Extraction
Voice and Accountability	1.000	.566
Political Stability	1.000	.667
Government Effectiveness	1.000	.580
Regulatory Quality	1.000	.711
Rule of Law	1.000	.788
Control of Corruption	1.000	.666

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component	
	1	2
Regulatory Quality	.843	
Control of Corruption	.749	-.324
Voice and Accountability	.728	
Political Stability	.692	.433
Rule of Law	.450	.765
Government Effectiveness	-.497	.577

Extraction Method: Principal Component Analysis.

a. 2 components extracted.

Rotated Component Matrix^a

	Component	
	1	2
Control of Corruption	.798	
Government Effectiveness	-.740	
Voice and Accountability	.703	
Regulatory Quality	.669	.513
Rule of Law		.884
Political Stability	.311	.755

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.^a

a. Rotation converged in 3 iterations.

Component Transformation Matrix

Component	1	2
1	.813	.582
2	-.582	.813

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.

Factor Analysis

KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.516
Bartlett's Test of Sphericity	Approx. Chi-Square	53.299
	Df	15
	Sig.	.000

Communalities

	Initial	Extraction
Voice and Accountability	1.000	.537
Political Stability	1.000	.795
Government Effectiveness	1.000	.695
Regulatory Quality	1.000	.903
Rule of Law	1.000	.606
Control of Corruption	1.000	.673

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component	
	1	2
Regulatory Quality	.930	
Government Effectiveness	.819	
Control of Corruption	.783	
Political Stability	.680	.576

Rule of Law		.763
Voice and Accountability	-.453	.576

Extraction Method: Principal Component Analysis.

a. 2 components extracted.

Rotated Component Matrix^a

	Component	
	1	2
Regulatory Quality	.942	
Control of Corruption	.820	
Government Effectiveness	.721	.419
Voice and Accountability	-.619	.392
Rule of Law		.771
Political Stability	.449	.770

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.^a

a. Rotation converged in 3 iterations.

Component Transformation

Matrix

Component	1	2
1	.943	.334
2	-.334	.943

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.

Factor Analysis

KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.664
Bartlett's Test of Sphericity	Approx. Chi-Square	71.427
	Df	15
	Sig.	.000

Communalities

	Initial	Extraction
Voice and Accountability	1.000	.865
Political Stability	1.000	.756
Government Effectiveness	1.000	.863
Regulatory Quality	1.000	.683
Rule of Law	1.000	.676
Control of Corruption	1.000	.848

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component	
	1	2
Control of Corruption	.918	
Government Effectiveness	.903	
Voice and Accountability	.887	
Political Stability	-.839	

Rule of Law		-.808
Regulatory Quality	.398	.724

Extraction Method: Principal Component Analysis.

a. 2 components extracted.

Rotated Component Matrixa

	Component	
	1	2
Voice and Accountability	.912	
Control of Corruption	.903	
Government Effectiveness	.874	.315
Political Stability	-.859	
Rule of Law		-.787
Regulatory Quality	.317	.763

Extraction Method: Principal Component Analysis.

Rotation Method: Varimax with Kaiser Normalization.^a

a. Rotation converged in 3 iterations.

Component Transformation Matrix

Component	1	2
1	.994	.109
2	-.109	.994

Appendix 3 GDP growth rate as sourced from: http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=BR , HDI data from http://hdr.undp.org/en/data																							
Year	Brazil			China		India		Malaysia		South Africa		Australia			United Kingdom		Germany		France			Italy	
	GDP	HDI		GDP	HDI	GDP	HDI	GDP	HDI	GDP	HDI	GDP	HDI	GDP	HDI	GDP	HDI		GDP	HDI		GDP	HDI
1994	5.335	0.64		13.052	0.538	6.659	0.453	9.212	0.675	3.2	0.652	4.038	0.876	3.885	0.826	2.457	0.828		2.345	0.818		2.151	0.793
1995	4.417	0.649		10.949	0.547	7.574	0.46	9.829	0.683	3.1	0.653	3.879	0.885	2.506	0.839	1.738	0.834		2.085	0.825		2.887	0.799
1996	2.208	0.656		9.928	0.557	7.55	0.468	10.003	0.695	4.3	0.651	3.949	0.888	2.549	0.843	0.818	0.84		1.388	0.83		1.286	0.805
1997	3.395	0.664		9.231	0.565	4.05	0.474	7.323	0.706	2.6	0.647	3.947	0.891	3.127	0.849	1.849	0.845		2.337	0.834		1.835	0.812
1998	0.338	0.671		7.838	0.574	6.184	0.481	-7.359	0.709	0.5	0.641	4.438	0.894	3.191	0.854	1.98	0.85		3.556	0.839		1.616	0.818
1999	0.469	0.677		7.667	0.583	8.846	0.489	6.138	0.715	2.4	0.635	5.007	0.897	3.283	0.86	1.987	0.855		3.407	0.844		1.56	0.823
2000	4.113	0.685		8.492	0.592	3.841	0.494	8.859	0.725	4.2	0.629	3.869	0.899	3.745	0.866	2.962	0.86		3.875	0.849		3.71	0.828
2001	1.39	0.692		8.34	0.6	4.824	0.499	0.518	0.723	2.7	0.62	1.929	0.902	2.726	0.87	1.695	0.867		1.954	0.851		1.772	0.836
2002	3.053	0.699		9.131	0.61	3.804	0.505	5.391	0.724	3.7	0.613	3.857	0.905	2.397	0.874	0	0.872		1.118	0.852		0.249	0.841
2003	1.141	0.695		10.036	0.622	7.86	0.518	5.788	0.731	2.949	0.611	3.071	0.908	3.466	0.878	-0.71	0.877		0.82	0.857		0.151	0.846
2004	5.76	0.694		10.111	0.634	7.923	0.526	6.783	0.734	4.555	0.609	4.149	0.91	2.528	0.886	1.17	0.884		2.786	0.86		1.582	0.851
2005	3.202	0.698		11.396	0.646	9.285	0.536	5.332	0.732	5.277	0.609	3.207	0.915	2.972	0.89	0.707	0.892		1.608	0.87		0.92	0.856
2006	3.962	0.7		12.719	0.659	9.264	0.546	5.585	0.736	5.585	0.612	2.983	0.918	2.503	0.889	3.7	0.898		2.375	0.873		2.007	0.862
2007	6.07	0.704		14.231	0.672	8.608	0.556	9.428	0.747	5.36	0.616	3.758	0.921	2.556	0.892	3.261	0.903		2.361	0.877		1.474	0.866
2008	5.094	0.714		9.654	0.682	3.891	0.563	3.32	0.756	3.191	0.622	3.707	0.925	-0.627	0.895	1.082	0.906		0.195	0.879		-1.05	0.868
2009	-0.126	0.716		7.4	0.691	8.48	0.569	-2.526	0.764	1.538	0.63	1.82	0.927	-4.328	0.895	-5.88	0.907		-2.94	0.879		-5.482	0.869
2010	7.528	0.724		10.636	0.7	10.28	0.58	6.981	0.774	3.04	0.638	2.018	0.927	1.915	0.902	4.06	0.912		1.966	0.882		1.687	0.872
2011	3.974	0.73		9.536	0.703	6.638	0.59	5.294	0.776	3.284	0.644	2.38	0.93	1.509	0.898	3.66	0.916		2.079	0.885		0.577	0.877
2012	1.921	0.734		7.856	0.713	5.484	0.599	5.474	0.779	2.213	0.652	3.633	0.933	1.313	0.899	0.492	0.919		0.183	0.887		-2.819	0.876
2013	3.005	0.747		7.758	0.723	6.54	0.607	4.693	0.783	2.33	0.66	2.44	0.936	1.911	0.904	0.49	0.92		0.576	0.89		-1.728	0.877
2014	0.504	0.754		7.298	0.734	7.179	0.615	6.012	0.787	1.629	0.665	2.5	0.937	3.07	0.908	1.595	0.924		0.637	0.894		0.092	0.881
2015	-3.769	0.754		6.918	0.738	7.934	0.624	4.962	0.789	1.265	0.666	2.24	0.939	2.194	0.91	1.721	0.926		1.274	0.897		0.732	0.887

Appendix 4 Panel and Logit Regression for all Economies							
	Earnings management Models with Interaction variables			Earnings management Models without Interaction variables			Logit Regression
VARIABLES	DisAccMJM	DisAccJM	DisAccPMM	DisAcc_MJM*	DisAccJM*	DisAccPMM*	IFRS_Adopt
IFRS	-0.172*** (0.000)	-0.186*** (0.000)	-0.210*** (0.000)	-0.002 (0.189)	0.010*** (0.000)	0.009*** (0.000)	
DISSUE	0.004** (0.028)	-0.003 (0.101)	-0.016*** (0.000)	0.004** (0.016)	-0.002 (0.212)	-0.015*** (0.000)	0.041 (0.512)
EISSUE	-0.003 (0.238)	-0.003 (0.122)	-0.011*** (0.000)	-0.003 (0.232)	-0.004 (0.110)	-0.011*** (0.000)	-0.026 (0.731)
TURNOVER	-0.031*** (0.000)	-0.032*** (0.000)	-0.039*** (0.000)	-0.030*** (0.000)	-0.034*** (0.000)	-0.040*** (0.000)	0.678*** (0.000)
CFO	-0.457*** (0.000)	-0.368*** (0.000)	-0.364*** (0.000)	-0.460*** (0.000)	-0.371*** (0.000)	-0.368*** (0.000)	0.057 (0.866)
ROTA	0.789*** (0.000)	0.634*** (0.000)	1.540*** (0.000)	0.787*** (0.000)	0.635*** (0.000)	1.541*** (0.000)	-0.044 (0.913)
LEV	0.000 (0.376)	-0.000 (0.944)	-0.001** (0.049)	0.000 (0.525)	-0.000 (0.567)	-0.001** (0.016)	-0.096*** (0.000)
GROWTH	-0.065*** (0.000)	-0.036*** (0.000)	-0.041*** (0.000)	-0.066*** (0.000)	-0.035*** (0.000)	-0.041*** (0.000)	-0.576*** (0.000)
SIZE	0.010*** (0.000)	0.012*** (0.000)	0.013*** (0.000)	0.009*** (0.000)	0.010*** (0.000)	0.011*** (0.000)	0.260*** (0.000)
AUD	-0.027 (0.623)	-0.111** (0.041)	-0.034 (0.603)	-0.029 (0.600)	-0.109** (0.044)	-0.034 (0.606)	-0.057 (0.223)
GDP	0.049* (0.071)	0.158*** (0.000)	0.208*** (0.000)	0.028 (0.301)	0.127*** (0.000)	0.171*** (0.000)	-16.884*** (0.000)
HDI	0.052** (0.048)	0.013 (0.630)	-0.007 (0.824)	0.149*** (0.000)	0.068*** (0.002)	0.071*** (0.007)	36.452*** (0.000)
ECOSTAT	-0.0026** (0.042)	0.00566 (0.0182)	-0.00293 (0.0246)	-0.0364** (0.0145)	0.0224 (0.0138)	0.00837 (0.0169)	-4.613*** (0.000)
GOVind	0.008*** (0.000)	-0.003* (0.058)	-0.003 (0.245)	0.012*** (0.000)	-0.001 (0.646)	0.001 (0.741)	-0.418*** (0.000)
IFRSGOV	-0.001 (0.964)	0.002** (0.024)	0.002 (0.168)				
IFRSHDI	0.257*** (0.000)	0.280*** (0.000)	0.316*** (0.000)				
IFRSECO	-0.056*** (0.000)	-0.058*** (0.000)	-0.062*** (0.000)				
IFRSAUD	-0.008*** (0.002)	-0.008*** (0.004)	-0.011*** (0.001)				
DisAcc_MJM							-26.463*** (0.000)
DisAccGov							0.967*** (0.000)
DisAccAud							-0.067 (0.873)
DisAccHDI							48.153*** (0.000)
DisAccECO							-18.975*** (0.000)
Constant	-0.190*** (0.000)	-0.132*** (0.000)	-0.302*** (0.000)	-0.251*** (0.000)	-0.153*** (0.000)	-0.333*** (0.000)	-28.264*** (0.000)
Observations	19,206	19,179	19,223	19,206	19,179	19,223	19,206
R-squared	0.271	0.220	0.451	0.268	0.215	0.448	

Number of FirmID	1,027	1,027	1,027	1,027	1,027	1,027	1,027	
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Appendix 4: Panel and Logit Regression for All Economies

pval in parentheses *** p<0.01, ** p<0.05, * p<0.1 represent 1%, 5% and 10% significance.