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The Adoption of IFRS and Earnings Management: Evidence from the Construction Industry in Malaysia

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Abstract

This study examines the effects of IFRS adoption on the quality of financial reporting (proxies by the level of earnings management) in Malaysia. The study measures the quality of Malaysian Construction companies through discretionary accruals yielded from 2008 to 2016. The sample comprises a balanced panel of 810 firm-year observations of Construction firms under the Main Board of Bursa Malaysia. This study accesses the effectiveness of effort by the Malaysian Accounting Standard Board (MASB) to improve the financial reporting by the revision process of the standard and their mandatory application. The accounting standard in Malaysia has closely followed the former International Accounting Standards (IAS) which is currently known as the International Financial Reporting Standard (IFRS). In November 2011, the Malaysian Accounting Standard Board (MASB) has issued the implementation of the Malaysian Financial Reporting Standard (MFRS). The full convergence is effective starting from 1st January 2012. One of the standards of MFRS 111 Construction Contracts focuses on construction companies. The construction industries have special financial reporting standards due to their unique features and the nature of their business activities. Therefore, this study is to examine the level of earnings management of Malaysian Construction companies during the period before the adoption of IFRS and the period after the adoption. The results show that there is a significant difference between the level of earnings management during the years before the adoption of IFRS and after the adoption of IFRS in Malaysia. This suggests that Malaysian construction companies have higher accounting qualities after the adoption period as compared to the period before the adoption of IFRS. Thus, the results of this study are expected to provide early evidence of the impact of adopting IFRS and give further direction for the regulatory bodies regarding the accounting standards and financial reporting practices in Malaysia. Future research perhaps could analyze the relationship of the characteristics of corporate governance in mitigating earnings management especially for the construction industries.

Keywords: Earnings management, financial reporting standards, earnings quality

1. INTRODUCTION

The accounting standard in Malaysia has closely followed the former International Accounting Standards (IAS) which is currently known as the International Financial Reporting Standard (IFRS). In November 2011, the Malaysian government, through the Malaysian Accounting Standard Board (MASB) has issued the implementation of Malaysian Financial Reporting Standard (MFRS). MASB is implementing its policy of full convergence by adopting IFRS as issued by the International Accounting Standards Board (IASB) for application, for annual periods beginning or after 1 January 2012. One of the standards of MFRS 111 Construction Contracts focuses on Construction Companies.

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Construction contract has been defined in FRS 111 as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their designs, technology and functions or their ultimate purposes or uses. FRS 111 further explains that construction contracts include: (a) contracts for the rendering of services which are directly related to the construction of the assets, for example, the services of project managers and architects; and (b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

The construction industries have special financial reporting standards due to their unique features and nature of their business activities. The most unique feature that makes this industry different is that their activities are carried out over more than one accounting period. Secondly, the recognition of the revenue during the development or construction involves the estimation during these periods (MASB 2007). Thirdly, the outcome of a construction project cannot be estimated reliably during the early stages of the project. Finally, the nature of this industry requires a huge amount of current assets especially materials and non-current assets for their operations which indirectly contribute to a large amount of accruals.

All these features are believed to provide greater opportunities for managers to manage their earnings through the recognition of revenues and expenses. Since the nature of this industry invariably covers more than one accounting period, managers will also have the discretion as to when they should manage their earnings. On top of that, the manager has the opportunity for earnings management due to the uncertainties inherent in the estimation of the cost and/or stage of completion of their project. The involvement of large amounts of current and non-current assets also gives the management greater opportunities to manage the discretionary accruals through accounts payable, accounts receivable and depreciation, while the nature of the sales process for the property industry has consequences for the recognition and measurement of the revenues and expenses (Wan Abdullah, 2013). The unique features and nature of the business activities for the Property and Construction industries provide greater opportunities for the managers to manage the earnings through the recognition of revenues and expenses.

The most common definitions of earnings management in the academic writing on accounting are from Schipper (1989) and Healy and Wahlen (1999). Schipper (1989) defines it as, *"an involvement in the process of preparing financial statements, purposely to acquire personal benefits".* A similar definition of earnings management as an opportunistic behaviour is expressed by Healy and Wahlen (1999) as follows:

> *"…earnings management occurs when managers use judgment in the financial reporting and 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 numbers."* (1999, p. 368)

Meanwhile, Ronen and Yaari (2008) offer an alternative view of earnings management and summarize the different definitions of earnings management by classifying them as white, grey and black. Earnings management is considered as beneficial (white) if it enhances the transparency of the reports; pernicious if it involves outright misrepresentation and fraud, and grey if the manipulation of reports is within the boundaries of compliance with bright-line standards, which could be the opportunistic of efficiency enhancing (Ronen & Yaari, 2008). They further claim that earnings management can be beneficial if it signals long-term value, pernicious if it conceals short or long term value, and neutral if it reveals the true short term performance.

The definitions of earnings management actually differ depending on the instruments of manipulation, the purpose of the earnings management behaviour, and its timing. Although defined in a variety of ways, the previous literature on the definitions of earnings management generally agree that it comprises the elements of an action purposely undertaken to alter the information in financial statements in order to mislead their users.

Basically, earnings management can be classified into two categories: accruals earnings management and real earnings management. Accruals earnings management happens when managers manipulate reported earnings by exploiting accounting discretion which is allowed under the Generally Accepted Accounting Principles (GAAP) to try to hide the true economic performance (Dechow & Skinner, 2000). On the other hand, real earnings management happens when managers attempt to alter reported earnings by adjusting the timing and scale of the underlying business activities, such as financing, investment or operating activities, in an effort to influence the output of the financial reporting (Roychowdhury, 2006). This study measures the quality of earnings through discretionary accruals. A low level of discretionary accruals, present a high quality of earnings information provided by a company.

Significant industry differences were found by Gu et al. (2005) in their research on the variability of accounting accruals, suggesting that different accounting choices are made by management in different industries. This study provides ongoing evidence on the impact of IFRS adoption on the earnings quality of Malaysian construction companies since little research has been conducted focusing on this industry, through discretionary accruals. Therefore, this study examines the level of earnings management of the construction companies in Malaysia during the period before the full adoption of IFRS and the period after the adoption.

2. FINANCIAL REPORTING STANDARDS IN MALAYSIA

In Malaysia, from 1978 to 1996, accounting standards were issued and enforceable under the codes of ethics by the professional accounting bodies, the Malaysian Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants (MICPA). However, the Malaysian Accounting Standard Board (MASB) which was established in 1997, under the Financial Reporting Act as the independent authority to develop and issue accounting and financial reporting standards in Malaysia, was given the force of law. The MASB has initiated a broad strategic direction in 2004 to align its accounting standards to those issued by the IASB to keep up with the development worldwide. The standards were renamed as Financial Reporting Standards (FRS) and renumbered to be in line with the standards issued by IASB to ease users and preparers in realizing the relationship between the two. The standards were revised in 2005 and again in 2007, with the aim of becoming virtually identical to the IASB standards. In 2008, the board issued an important statement about their plans to bring Malaysia to full convergence with IFRS by 1 January 2012. A new IFRS-compliant framework, known as the MFRS Framework was introduced and applicable effective 1 January 2012. This includes IFRS111 Construction Contract for Construction companies. MFRS 111 differs from the previous IAS 11 with some amendments especially when it comes to the recognition and determination of contract revenues and contract costs.

There are several advantages of adopting IFRS as claimed by MASB. Firstly, it will help users of financial statements, especially investors, in understanding the information provided and making comparison between companies around the globe. Thus, it is essential to use internationally recognised standard for financial reporting purposes. Secondly, it will enhance national reputation and consequently ensure that Malaysia will not be left behind by the globalisation wave since more than 100 countries are converging or have converged to or adopted IFRS. This will ensure that Malaysian companies will be recognised in the eyes of the international investors. Thirdly, it will provide greater credibility and transparency to financial reporting in Malaysia and making it easier for the global investors to understand and rely on the information provided. Fourthly, by adopting the international standards, it will assist Malaysian corporations to have better practices. Fifthly, multinational companies in Malaysia are expected to get the advantage from the reduced compliance costs and reduced translation risks when consolidating the multiple international subsidiaries into a single set of consolidated financial statements. Finally, companies, no matter how big or small, are able to attract capital from the international investors, driving down the cost of capital and facilitating the cross-border mergers and acquisitions activities and strategic investments (MASB, 2017).

However, besides all the advantages, there are also some disadvantages of converging with IFRS. Sidik and Abd Rahim (2012) provide evidence from the perspective of accounting practitioners in Malaysia that IFRS has brought substantial benefits to business organisations, especially with regards to the investor confidence, because the adoption of the IFRS has led to greater transparency and comparability. They documented that the high costs was the biggest challenge faced by the respondents because they needed to pay for staff training, engaging the specialists, upgrading their system and bear higher audit fees.

The research findings by Abdullah and Sapiei (2013) highlighted the advantages and disadvantages of IFRS from the perspective of practitioners in Malaysia. Their results suggested although the full convergence with IFRS benefitted Malaysian companies, there are problems and challenges that will be faced by companies in complying with IFRS. Such problems are, increasing complexity in the work scope for auditing, involving higher costs and consuming more time in training the accounting staff and employing experts, contributing higher compliance cost as undeveloped capital market did not facilitate compliance with the fair value of the accounting standards.

3. LITERATURE REVIEW

International Financial Reporting Standards (IFRS) is a set of accounting standards developed by the International Accounting Standards Board (IASB) that is becoming a global standard for the preparation of general purpose financial statements that are intended to meet the needs of the users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

IFRS are issued by the International Accounting Standards Board (IASB) since April 2001, when the IASB took over the responsibility of the International Accounting Standards Committee (IASC). The IASC issued International Accounting Standards (IAS), which were later revised and adopted to IFRS. IASB was established in order to produce a single set of high quality, understandable and enforceable international financial reporting standards to improve the quality of financial information. To achieve this goal, IASB has issued principles-based standards, limited allowable alternative accounting practices and required accounting measurements that better reflects a firm's underlying economic position and performance (IASC, 1989).

IFRS removes allowable accounting alternatives and early evidences show that it has limited managerial discretion to manipulate earnings. Thus, adopting IFRS helps improving the earnings quality. Therefore, adopting a high quality of accounting standards is essential because it would be able to enhance earnings quality through the ease of monitoring and comparison of financial reports across boarders which put pressure on the management to report faithfully and truthfully (Soderstrom & Sun 2007).

The adoption of IFRS is considered as beneficial to the adopting countries since IFRS's standards have excellent reputation and credibility. IFRS offers a more accurate, comprehensive and timely financial statement information, relative to the national standards they replace for the public financial reporting (Ball 2006). An important feature of IFRS is the use of a fair value accounting, instead of historical cost accounting. The main benefit of a fair value accounting is that it provides accurate asset and liability valuation on an ongoing basis to users of a company's reported financial information which provides better insight for them in decision making. Besides, IFRS requires greater level of disclosure which can be linked to an increase in the quality of reported information (Wan Ismail et al. 2013). Due to its reputations, the IFRS standards have gained global acceptance and implementation, largely rests on its principles-based nature as well as on its driving notions of openness and flexibility (Carmona & Trombetta, 2008).

There are growing numbers of studies investigating on the adoption of IFRS with various perspectives at different background settings. The studies conducted by previous researchers found that countries that adopt IFRS have lower level of earning management. A prior study done by Ewert and Wagenhofer (2005) presents evidence that tightening the accounting standards that limits opportunistic discretion result in accounting earnings that are more reflective of a firm's underlying economics, therefore, improve reporting quality. The study done by Barth, Landsman, and Lang (2007) further explores the quality of accounting amounts for IAS firms after applying IAS. Barth et al. (2007) find that firms adopting IFRS have lesser earnings management, more timely loss recognition and more value relevance of earnings, all of which they interpret as evidence of higher accounting quality. Similarly, Chua, Cheong and Gould (2012) find that the mandatory adoption of IFRS in Australia has resulted in better accounting quality than under the Australian Generally Accepted Accounting Principles (GAAP) previously. The findings indicate that the pervasiveness of earnings management by way of smoothing has reduced, while the timeliness of loss recognition has improved as well as the value relevance of financial statement information has also improved.

In addition, Zhou, Xiang and Ganguli (2009) show that adopting firms in China are less likely to smooth earnings in the post adoption period and suggest that the improvement in the quality of accounting information is related with the adoption of IFRS. Meanwhile, Iatridis (2010) who examines the implementation of IFRS in the U.K. shows evidence that it reduces the scope for earnings management which is related to a more timely loss of recognition which leads to more value relevant accounting measures. The evidence should be able to assist investors in making informed and unbiased judgements. On top of that, Landsman, Maydew and Thornock (2012) present evidence that suggests information content increased in 16 countries that mandated the adoption of IFRS relative to 11 that maintained domestic accounting standards. Three mechanisms are found by them that show that IFRS adoption increases information content, reduces reporting lag, increases analyst following, and increases foreign investment.

In a larger scale, Hoque, Zijl, Dunstin and Karim (2012), examine the effects of mandatory IFRS adoption and investor protection on the quality of the accounting earnings in forty-six countries around the world. They present evidence that suggests earnings quality increases for mandatory IFRS adoption when a country's investor protection regime provides stronger protection. A more recent study by Brochet, Jagolinzer and Rield (2013) measures the effects of mandatory IFRS adoption in financial statement comparability in U.K. Their findings are consistent with the mandatory IFRS adoption which improves comparability and thus leading to capital market benefits by reducing insiders' ability to exploit the private information.

However, there are contradicting evidences with the findings in earlier studies which suggest that IFRS adoption might lead to the increase in accounting quality. Previous study by Jeanjean and Stolowy (2008) finds that the pervasiveness of earnings management did not decline after the introduction of IFRS, and in fact, increased in France. In addition, Callao and Jarne (2010) provide results that suggest earnings management has increased in the period following the adoption of IFRS in the European Union. They assume that the variations in earnings management might be due to some room for manipulation under the international standards when compared to the local standards.

Ahmed, Neel and Wang (2013) find that IFRS firms exhibit significant increase in income smoothing and aggressive reporting of accruals, and a significant decrease in timeliness of loss recognition. A more recent study by Capkun, Collins and Jeanjean (2016) reported that an increase in earnings management (smoothing) from pre-2005 to post-2005 for firms in countries that allowed early IAS/IFRS adoption, as well as for firms in countries that did not allow early IFRS adoption. They claim that the IFRS standards that went into effect in 2005 provide greater flexibility of accounting choices because of the vague criteria, with the lack of clear guidance on how to implement these new standards that led to greater earnings management (smoothing).

Based on the above arguments and conflicting findings, this study hypothesises that:

H1: The level of earnings management is lower after the adoption of IFRS.

This study can be extend to the existing knowledge of earnings management and the adoption of IFRS as the area of investigation is very unique: specifically that of Construction companies in Malaysia, a sector in which still little studies have been undertaken to date. It is predicted that firms with higher earnings quality exhibit less earnings management. This study, therefore, examines the level of earnings management of the construction companies in Malaysia during the period before the full adoption of IFRS and the period after its adoption. When the level of earnings management is reduced, this should improve the financial information or earnings quality provided by the company.

4. RESEARCH METHODOLOGY

4.1 Measurement of Earnings Management

The main objective of this study is to examine the level of earnings management of Malaysian construction companies during the period before the adoption of IFRS and the period after its adoption. To this end, a well-recognised earnings management models, Modified Jones Model by Dechow, Sloan and Sweeney (1995) have been employed. Although some argue the ability of Modified Jones Model to detect earnings management, Dechow et al., (1995) and Guay, Kothari, and Watts (1996) contend that the modified model is the most powerful mechanism to detect earnings management in the context of managers exercising their discretion over revenue recognition.

$$TACC_{it} = NI_{it} - CFFO_{it} \tag{1}$$
$$NDAC_{it} = \alpha_i[1/TA_{it-1}] + \beta_1[(\Delta REV_{it} - \Delta REC_{it})/TA_{it-1}] + \beta_2 PPE_{it}/TA_{it-1} \tag{2}$$
$$TACC_{it}/TA_{it-1} = \alpha_i[1/TA_{it-1}] + \beta_1[(\Delta REV_{it} - \Delta REC_{it})/TA_{it-1}] + \beta_2 PPE_{it}/TA_{it-1} + \varepsilon_{it} \tag{3}$$
$$DACC_{it} = \varepsilon_{it} = TACC_{it}TA_{it-1} - NDAC_{it} \tag{4}$$

Where; $DACC_{it}$ is the discretionary accruals in year t, $TACC_{it}$ is the total accruals in year t, $NDAC_{it}$ is the nondiscretionary accruals in year t, TA_{it-1} is the total assets in year t-1, NI_{it} is the net income in year t, $CFFO_{it}$ is the net cash flow from operations in year t, ε_{it} is the error term in year t, and i is the individual firm in year t. The coefficients in equation 2 for each year are applied in equation 3 for each company accordingly. DACC is the error terms in equation 3.

This study will use discretionary accruals (DACC) as the measurement of earnings management. As in other research, the total accruals (TACC) are assumed to be the sum of nondiscretionary accruals (NDAC) and discretionary accruals (DACC), therefore, discretionary accruals will be the difference between total accruals and nondiscretionary accruals, i.e. DACC = TACC – NDAC. Similar to previous study by Collins and Hribar (1999) and Houqe et al. (2012), this study also uses the Cash Flow approach to calculate the total accruals (TACC). Hribar and Nichols (2007) reported of empirical evidence suggesting that signed discretionary accruals were a better measure of earnings quality than absolute discretionary accruals. All variables in the regression model are deflated by total assets to reduce heteroscedasticity problems (Abdul Rahman & Wan Abdullah, 2005; Dechow et al., 1995; Jones, 1991; Klein, 2002; Kothari et al., 2005).

4.2 Sample and Data Collection

The population of interest in this study covers all construction companies listed on the Main Board, of Bursa Malaysia for the year 2008 that are continuously listed until 2016. The convergence of IFRS is applicable and effective starting from 1st January 2012. As a result, we define before IFRS adoption era for construction companies in Malaysia from 2008 to 2011, while after adoption period comprises the years 2013 to 2016. Year of implementation, 2012, is not chosen because there is a possibility that the construction firms may not be able to comply with the requirements of the new set of accounting standards during the year of transition.

The required data of the study are obtained from DataStream databases from 2008 to 2016. The population of this study consists of all the firms listed under the Construction Industry on Main Board of Bursa Malaysia. Those companies being unlisted during the study period as well as those with incomplete data were excluded from the studies. A final sample of 90 firms, which generate a balanced panel of 810 firm-year observations.

5. RESULTS AND DISCUSSION

5.1 Descriptive Statistics

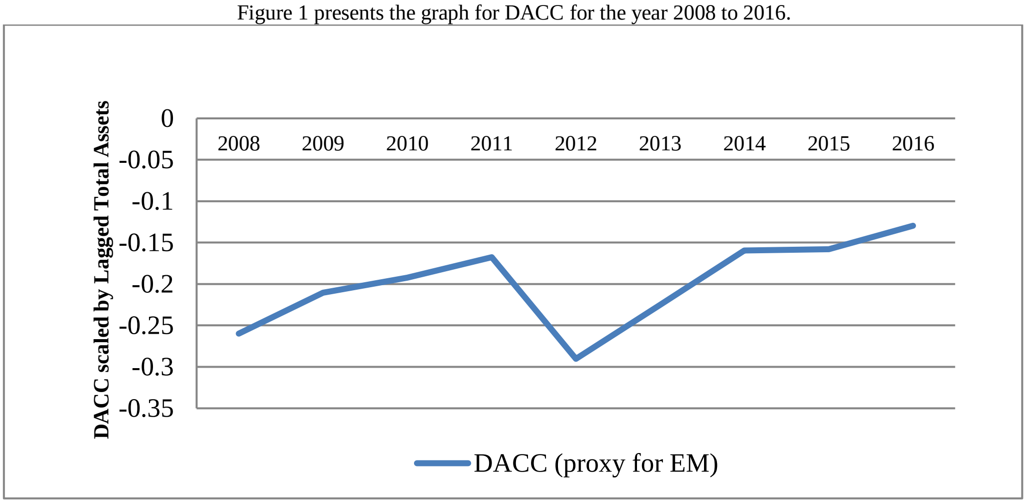
Table 2 presents the descriptive statistics for discretionary accruals (DACC as a proxy of earnings management) for the year 2008 to 2016.

Table 2. Descriptive Statistics of Earnings Management for the year 2008 - 2016

	Minimum	Maximum	Mean	Std Deviation
DACC2008.	-.9128	.1528	-.259703	.2185591
DACC2009.	-1.0853	.4593	-.210282	.2515491
DACC2010	-.6825	.4199	-.192222	.2330385
DACC2011	-.7159	.4073	-.167453	.1976957
DACC2012	-1.1309	.7451	-.290289	.2616350
DACC2013	-1.0633	.5292	-.224990	.2609498
DACC2014	-.6391	.3039	-.159485	.2380104
DACC2015	-.6408	.4187	-.158112	.2369161
DACC2016	-.8499	.3992	-.129618	.2220304

In the sample, 81 percent of the companies had a negative DACC, while the other 19 percent had positive DACC. The results suggest that the majority of the companies manage their earnings via income decreasing accruals. A possible reason for income decreasing accruals is to avoid higher expectations from investors and/or to reduce income taxes.

Figure 1 presents the graph for DACC for the year 2008 to 2016.



The figure depicts that the figure for DACC is quite high in 2012. This is consistent with the argument by the PricewaterhouseCoopers Senior Executive Director and Corporate Reporting Leader, Ng Mi Li (PWC Alert, 2005), because 2012 is the transition period and it would result with in greater volatility of company results. However, the results suggest that the level of earnings management decreases from -0.290289 to -0.129618 during the period after the full adoption of IFRS.

5.2 Earnings Management Before and After the Full Adoption of IFRS

Table 2 summarizes the descriptive statistics of earnings management for the year before and after the full adoption of IFRS, specifically MFRS111 for construction companies, in Malaysia.

Table 2. Descriptive Statistics of Earnings Management for the year Before and After the Adoption of IFRS

	Minimum	Maximum	Mean	Std Deviation
DACC2008-2011	-1.0853	.4593	-.207415	.2276565
DACC2013-2016	-1.0633	.5292	-.168051	.2414290

Table 3 presents the results of Paired Sample t Test of earnings management for the year before and after the adoption of IFRS, specifically MFRS111 for construction companies, in Malaysia.

Table 3. Paired Sample T Test of Earnings Management for the year Before and After the Full Adoption of IFRS

	Mean	Std Devation	Std Error Mean	95% Confidence Interval		t	df	Sig 2 tailed
				Lower	Upper			
DACC2008-2011	-1.0853	.4593	-.207415			-2.683	359	.008
DACC2013-2016	-1.0633	.5292	-.168051	-.0682147	-.0105130	-2.683	359	.008

The results shows that there is a significant difference between the level of earnings management during the year before the adoption of IFRS and after the adoption IFRS in Malaysia. The mean for the year before adoption is -1.0853 and the mean for the year after the adoption is -1.0633. The results for both years suggest that the construction companies manage their earnings using the income decreasing accruals. However, after the adoption of IFRS, the mean is lower and it is significant at 1% level using Paired Sample T Test. This indicates that Malaysian construction companies have higher accounting qualities after the adoption period as compared to the period before the adoption of IFRS. After the adoption of IFRS, the results suggest a reduction, but does not eliminate, earnings management. The result is consistent with the findings by Barth et al (2007), Zhou et al. (2009), Iatridis (2010), Chua et al. (2012), Sellami and Slimi (2016) and Wan Ismail et al (2013). However, this study contributes to the knowledge on earnings management and the adoption of IFRS, as the area of the study focuses on the construction industry with unique features and nature of business as compared to the other industries in Malaysia.

6. CONCLUSION

This study measures the effectiveness of the effort in mitigating earnings management after the adoption of IFRS by the issuance of MFRS 111 for the construction industry in Malaysia. The findings indicate that the adoption of IFRS on MFRS reduces the level of reported discretionary accruals of Malaysian construction companies. Thus, the results of this study is expected to provide early evidence of the impact of adopting IFRS and give further direction for the regulatory bodies pertaining to the accounting standards and financial reporting practices in Malaysia. Finally, future research could analyze the relationship of the characteristics of corporate governance in mitigating earnings management especially in construction industries.

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