# THE EFFECT OF IFRS ADOPTION LEVEL ON THE QUALITY OF FINANCIAL REPORTING IN MANUFACTURING COMPANIES IN ASEAN

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**Abstract:** The purpose of this study is to analyze the effect of IFRS adoption level on the quality of financial reporting of manufacturing companies in ASEAN in which the application of IFRS is expected to increase the earnings quality. The research method used is quantitative study with purposive sampling method. Based on the spesific criteria sample, the number of 399 listed companies from 2010 to 2013 with 1596 firm-year observations are selected. To analyze the quality of financial reporting of sampled companies, is uses Penman proxy to measure earnings quality based on conservatism principle.

The result shows that IFRS adoption level has a positive effect on the quality of financial reporting of manufacturing companies in ASEAN. However only 2,2% changes in the quality of financial reporting caused by IFRS adoption. Listed companies in ASEAN countries then should consider and know how much differences that occurs when adopting IFRS by considering the cost and benefit and adjust it with the economic, law, and political conditions of the country.

**Keywords:** IFRS Adoption, Quality of Financial Reporting, Penman Proxy

## INTRODUCTION

Globalization brings a fundamental influence on the movement of information and capital. Multinational Corporation (MNC) operating in various countries with a wide range of financial reporting standards. Meanwhile for the investment decision, investors require economic information from related companies. This condition requires the accounting system and financial reporting in a uniform and generally accepted by various countries. Accounting as an information provider for economic decision-making is also influenced by the business environment that constantly changing due to globalization.

Financial statement is a record that outline the financial activity and describe the financial condition of the company as the reference in decision making by the stakeholders. Financial statement must be presented in accordance with generally accepted accounting and

financial reporting principles. An accounting and financial reporting principles accepted in a country may not necessarily generally accepted in other countries. Harmonization of accounting standards and financial reporting around the world is absolutely must be done.

The ASEAN Economic Community (AEC) shall be the goal of regional economic integration by 2015. AEC envisages the following key characteristics: a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy. Once AEC is realised, ASEAN will be characterized by free movement of goods, services, and investments as well as free flow of capital and skills. With harmonised trade and investment laws, ASEAN, as a rule-based organisation will be strengthened and become more interesting as a single investment destination. Consistent with the goal, AFA (ASEAN Federation of Accountants) encouraged its members to go for harmonization of standards and practices based on issuance of IASB and IFAC. In this respect, AFA has been successful since most of its members have adopted international accounting standards into their national accounting standards.

Achieving the objective of AEC translates to a better investment climate in ASEAN. The AEC facilitates the implementation of trade, service, investment, and other reforms necessary in each ASEAN Member States, thereby improving each country's location offers. At the regional level, the AEC is critical in developing the ASEAN as a region and making it one of the most competitive economic blocs in the world. This is done in order to increase the competitiveness of ASEAN to compete China and India to attract foreign investment. Foreign investment in this area is needed to boost employment and improving the well-being (www.bbc.co.id).

Capital market plays a vital role in the economy of all countries. This market not only activates dull money and investment via companies but also acts as an economical prosperity index. So, paying attention to this market and the decision making principles of it, is

essential. One of the key elements of decision making in such markets is their financial statement and specially their income statement which represents the results of an entity's operational activities in a financial period and its bottom line is assumed as the basis for most of decisions made, assessment models and stock pricing, so that its accuracy, precision, reliability ,assurance, predictability and realization have a direct relationship with decision making accuracy and assessment.

From these problems, a thing to be questioned is whether to adopt international accounting standards, IFRS, which is done at various levels, can improve the quality of financial reporting, especially companies in ASEAN countries. When IFRS can not make a better reporting, then one of the objectives of the IASB to develop a set of high-quality accounting standards that demands a high-quality information can not be achieved. Existing literature supports this view that adoption of IFRS as a single set of reporting standards improves the quality of financial information and also ensures timely loss recognition. Summarily, adopting single set of Financial Reporting Standards bring many benefits to reporting entities, Investors, Bankers and other interested parties as in this period of International boundaries getting eliminated, they will not have to refer Reporting Statements prepared on the basis of different reporting standards.

**THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT**

**Positive Accounting  Theory (PAT)**

Positive accounting theory is an attempt to provide some explanation of accounting practice rooted  in the purposes of managers. Simply stated, these purposes of managers, as initially described by Watts & Zimmerman (1978), are reducible to economic self-interest. That is, when choosing accounting procedures managers consider only the effect of the procedures on their wealth; chioces are wealth-maximizing given the constraints imposed by

other wealth-maximizing agents (e.g., shareholders, bondholders). Further, it is presumed that managers maximize their wealth if they choose those accounting procedures that maximize the value of the firm and/or maximize manager compensation via compensation agreements tied to accounting members. The list of wealth-affecting costs is familiar, e.g., political costs, bookkeeping costs, taxes,contracting costs.

PAT explains "why accounting is, what it is, and why accountants do what they do", and what the effects of this phenomenon on the human and resource users. PAT's concern lies in the prediction of the behavior of managers in selecting accounting policies and how managers will respond to the application of new accounting standards. Although PAT can not certainty predic the real events, at least PAT helps in understanding the key factors underlying the behavioral tendencies manager. According to Januarti (2004), although PAT can not predict with certainty the real events, at least PAT helps in understanding the key factors underlying the behavioral manager tendencies.

PAT view that companies organize themselves in the most efficient way. The most efficient form of organization for a particular company depends on some factors, such as law and institutional environment, technology and the level of competition in the industry, where these factors determine a set of investment opportunities available to the company and its prospects. For example, how accounting harmonization or IFRS adoption can determine investment opportunities to the company. PAT emphasizes the need for empirical investigation to determine its accounting policies, how it vary from one company to another depending on the form of the organization and factors determine opportunities and prospects to the company. The objectives of PAT is to understand and predict the choice of accounting policy between different companies.

**Hypothesis Development**

This study aimed to examine whether the level of adoption of IFRS may affect the quality of financial reporting. Are companies that have adopted IFRS have a better quality of financial reporting than companies that do not apply the IFRS standards in its financial reporting.

The IFRS adoption level divided into five levels, namely full adoption, adopted, piecemeal, referenced, and not adopted at all. With fully adopt IFRS, companies are required to do more disclosure. IFRS provide limitations for the management of the company to choose the desired method of accounting in accordance with generally accepted accounting principles. Thus, the adoption of IFRS is expected to improve financial reporting quality. Thus hypothesis of this study is:

Ha: IFRS adoption level affects the quality of financial reporting in manufacturing companies in ASEAN

**RESEARCH METHOD**

**Population and Research Sample**

The population in this study are listed manufacturing companies in ASEAN countries from 2010 to 2013. Sample were selected using purposive sampling method. Sample is determined by several criteria, such as:

1) Manufacturing companies comes from five types of industries, such as automobile & parts, electronic and electrical equipment, food producer, general industrial, and pharmaceutical and biotechnology.

2) The company issuing financial statement in 2010-2013.

3) The company has financial period ended 31 December.

4) The financial statement of the company in the period under study must contain information needed.

**Types and Source of Data**

The type of data in this research is a quantitative data for the quality of financial reporting variable, qualitative data is quantified by using a Likert scale for the IFRS adoption level, as well as the qualitative and quantitative data for the purposes of descriptive statistics. Sources of data from this study are secondary data derived from the financial statements and audit report of the listed companies are used as samples, research result conducted by Pricewaterhouse Coopers and IFRS Foundation, and related information from another sources such as websites, databases, publications, etc.

**Operational Definition and Measurement Variables**

1. IFRS Adoption Level

   The IFRS adoption level is a measure of the degree to which the adoption of IFRS has been made by a country or company as the accounting standards used in the company's financial reporting process. IFRS adoption level of the listed company can be determined by observing the accounting standards applicable in the country where the listed company is registered as well as by observing the accounting standards that are required to be used by listed company in the country.

   According to Dewan Standar Akuntansi Keuangan (DSAK), IFRS adoption level can be divided into five levels, namely:

   a. Full Adoption

      An entire country adopts IFRS products and translate into the language spoken in the country.

   b. Adopted

      Adopt all IFRS but adapted to the conditions in the country.

c. Piecemeal

A country is only partially adopted the IFRS numbers, numbers of certain standards and choose certain paragraphs.

d. Referenced

As a reference, the standard applied only refers to certain IFRS with language and paragraphs are compiled by standards boards.

e. Not Adopted at all

A country not adopted IFRS at all.

Measurement of the IFRS adoption level variable in this study using a Likert scale with a score of 1 to 5 based on the rate of adoption of IFRS are divided into five levels. Likert scale starts from a score of 1 for a not-adopted at all up with a score of 5 for full adoption.

2. Quality of Financial Reporting

The definition of financial reporting quality is still diverse, but in principle the definition of financial reporting can be viewed in two perspectives. The first view states that financial reporting quality is closely related to the performance of the company are realized in corporate profits earned in the current year. The second view states that financial reporting quality related to the company's stock performance in the capital market. Thus financial reporting quality is a construct that can be analyzed in two views, that is financial reporting quality relating to cash and profit itself (accounting-based attributes), or financial reporting quality related stock exchange (market-based attributes) (Fanani, 2009).

According to Ball (2006), the quality of financial reporting in general is how the financial reporting provides something in accordance with the needs and objectives. Financial reporting is said to be high quality if it is able to provide useful

information for the needs of various users of financial reporting, including investors. Financial reporting should be in accordance with the economic reality, low manipulation by management, and timely to be high quality financial reporting. By the time quality of financial reporting is seen through the accounting-based attributes, financial reporting information is said to be high (quality) if the profit for the year can be a good indicator for corporate profits in the future (Lev and Thiagarajan, 1993) or strongly associated with operating cash flow in the future (Dechow and Dichev, 2002).

This study uses a proxy (approach) Penman as an indicator of the quality of financial reporting. This criterion measures the quality using conservatism principle. Since cash items can less be manipulated , this is done via non-operational accrued revenues and costs. With this, the earning quality decreases, too (Penman, 2002). In these circumstances, "operational cash flow to net profit ratio " is used to measure earnings quality. This measuring of earnings quality is based on the notion that the closeness to cash means higher quality earnings, as mentioned by Penman (2001). If the management using conservatism has been avoiding to identify some of net earnings, this ratio would increase and this increasing means diminishing of earnings quality. In other words, the more conservative management means the more this ratio and the less earnings quality would be (Penman, 2002).

**RESULTS**

**Sample Selection**

The companies that became sample in this study is collected using purposive sampling method. Based on the purposive sampling method, criteria for the companies  that became sample in this research is a manufacturing companies that has a complete data in accordance with the variables used in this research, manufacturing companies comes from

five types of industry, such as automobile & parts, electronic and electrical equipment, food producer, general industrial, and pharmaceutical and biotechnology, and the selected companies are the companies that issues the financial statements during 2010 to 2013 with financial period ended December 31. With the criteria established at the beginning of the research, this process yields a sample of 399 companies and 1596 firm-year observations out of total population

**Descriptive Statistics**

Descriptive statistics in this research is used to describe the variables. These variables include the quality of financial reporting variable which can be measured by earning management calculated by Penman proxy as the dependent variable. IFRS adoption level variable are measured using a Likert scale where score 5 for Full Adoption, 4 for Adopted, 3 for Piecemeal, 2 for Referenced, and 1 for Not adopted at all. In this research, descriptive statistics that used include, mean, maximum, minimum, and standard deviation shown in appendix 1.

**Classical Assumption Test**

Classical assumption test is used to determine whether all the necessary assumption are met and to avoid bias because not all data can be applied in regression. Normality data testing is conducted by using Kolmogorov Smirnov test. Refer to appendix 2 can be expalined that the figures Kolmogorov Smirnov significance of 0,096. Therefore, based on these data, it can be explained that the regression model used for prediction dependent variable financial reporting quality through independent variable IFRS adoption are worthy. Based on heteroscedasticity test output using Glesjer method in appendix 3, the Sig. is 0,089. This value is greater than 0,05, means that the regression model is free from heteroscedasticity. Autocorrelation test is used to determine whether there is a correlation between error in t period with the error in t-1 period. Refer to appendix 4, the result obtained

by calculating the value of the Durbin Watson Test for financial reporting quality as dependent variable is 1,957 that means no autocorrelation.

**Simple Linear Regression**

Regression analysis resulted coefficients for each independent variable that indicates how much influence each independent variable on the dependent variable. Based on the output of simple linear regression analysis shown in appendix 5, the regression equation is:

$$Y = 1,691 + 0,13 \, x$$

Description:

$Y$ = Quality of Financial Reporting

$x$ = IFRS Adoption Level

Coefficient of determination ($R^2$) is used to measure how close the data are to the fitted regression line. Refer to appendix 5, based on the linear regression analysis output the value of coefficient of determination is 0,022, therefore about 2,2% of the variation in quality of financial reporting data is explained by IFRS adoption level, while the other 97,8% of the variation is influenced and predicted by another variables outside the model.

**Hypothesis Testing**

Hypothesis testing is used to determine whether there is a real effect of the independent variable IFRS adoption level on the dependent variable the quality of financial reporting. Refer to appendix 5, based on the linear regression analysis output using t-test, Ha which states that IFRS adoption level affects the quality of financial reporting in manufacturing companies in ASEAN is **accepted.**

Based on the result of hypothesis testing that have been done states that the IFRS adoption level affects the quality of financial reporting in manufacturing companies in ASEAN. This result is consistent with the hypothesis that has been formulated in the beginning. In addition, based on the regression equation the effect of IFRS adoption level on the quality of financial reporting has a positive direction. It means that by adopting IFRS the

quality of financial reporting in manufacturing companies in ASEAN is increasing. Based on this research, it can be proved that as international accounting standards IFRS is able to make a better financial reporting. This is consistent with the goal of IASB which is to develop accounting standards that require a high quality information.

The findings of this study are consistent with several previous literature, although there is differences in the method used in this study compared with previous studies. Research conducted by Chica (2013), Ta and Liu (2014) found that quality of financial reporting has increased in the period after the convergence to IFRS. Another research conducted by Barth, Landsman and Lang (2008) and Rajihie (2014) also found that companies that applied IAS has a higher quality of financial reporting compared to companies that do not applied IAS.

Although IFRS adoption level has a real impact on the quality of financial reporting in manufacturing companies in ASEAN, but the value of coefficient of determination is only 2,2%. It means that changes in the quality of financial reporting influenced by IFRS adoption level is only 2,2%, while the other 97,8% of the variation is influenced and predicted by another variables outside the model. In other words, IFRS adoption level only has a little effect on the quality of financial reporting in manufacturing companies in ASEAN.

**CONCLUSION, IMPLICATION AND LIMITATION**

The main objective of this study is to examine the effect of IFRS adoption level on the quality financial reporting by using a sample of Founding Fathers of ASEAN, such as Indonesia, Malaysia, Philippines, Singapore and Thailand. Penman index are used to measure the quality of financial reporting.

Based on the analysis and discussion could be concluded that IFRS adoption level has a positive effect on the quality of financial reporting in manufacturing companies in ASEAN. IFRS adoption level has a little effect on the quality of financial reporting which is only 2,2%

changes in the quality of financial reporting in manufacturing companies that are affected by IFRS adoption level.

Although accounting standards have now been harmonized in many countries, the lack of uniformity and comparability in the enforcement of accounting standards across borders reduces the benefits of IFRS adoption to improve accounting quality, which is concern to accounting standards setters, regulators and investors.

This study has some limitation that may be a suggestion for further research. In this study the method used to measure the financial reporting quality is only Penman proxy. For further research, it is recommended to use other proxies, such as Leoz, Modified Jones model, or Dichev and Dechow model, because it may show a different result. Independent variable used in this study is only IFRS adoption level. There may other variables that have a positive infulence on financial reporting quality. For further research, it is recommended to add more independent variables. Manufacturing companies are the only sample used in this research. For further research, it is recommended to add more samples from other industries.

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**APPENDIX**

## Appendix 1. Descriptive Statistics

**Descriptive Statistics**

|  | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| FR_Quality | 1596 | -990.5980 | 885.7027 | 1.090818 | 38.3208389 |
| IFRS_Adoption | 1596 | 2.00 | 5.00 | 3.1617 | 1.12879 |
| Valid N (listwise) | 1596 |  |  |  |  |

## Sample Distribution Based on The Country

**Country**

|  |  | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Indonesia | 74 | 4.6 | 18.5 | 18.5 |
|  | Thailand | 34 | 2.1 | 8.5 | 27.1 |
|  | Singapura | 96 | 6.0 | 24.1 | 51.1 |
|  | Philipina | 5 | .3 | 1.3 | 52.4 |
|  | Malaysia | 190 | 11.9 | 47.6 | 100.0 |
|  | Total | 399 | 25.0 | 100.0 |  |
| Missing | System | 1197 | 75.0 |  |  |
| Total |  | 1596 | 100.0 |  |  |

## Sample Distribution Based on IFRS Adoption Level

**IFRS Adoption**

|  |  | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Referenced | 622 | 39.0 | 39.0 | 39.0 |
|  | Piecemeal | 380 | 23.8 | 23.8 | 62.8 |
|  | Adopted | 308 | 19.3 | 19.3 | 82.1 |
|  | Full adoption | 286 | 17.9 | 17.9 | 100.0 |
|  | Total | 1596 | 100.0 | 100.0 |  |

**Sample Distribution Based on Financial Reporting Quality**

**Financial Reporting Quality**

| | | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | Low | 655 | 41.0 | 41.0 | 41.0 |
| | High | 941 | 59.0 | 59.0 | 100.0 |
| | Total | 1596 | 100.0 | 100.0 | |

**Appendix 2. Normality Test**

**One-Sample Kolmogorov-Smirnov Test**

| | | Unstandardized Residual | Standardized Residual |
|---|---|---|---|
| N | | 1596 | 1596 |
| Normal Parameters[a,b] | Mean | -.1973 | -.0913 |
| | Std. Deviation | .15814 | .15814 |
| Most Extreme Differences | Absolute | .198 | .198 |
| | Positive | .147 | .147 |
| | Negative | -.817 | -.817 |
| Kolmogorov-Smirnov Z | | 1.432 | 1.432 |
| Asymp. Sig. (2-tailed) | | .096 | .096 |

a. Test distribution is Normal.

b. Calculated from data

## Appendix 3. Heteroscedasticity Test

**Variables Entered/Removed[b]**

| Model | Variables Entered | Variables Removed | Method |
|---|---|---|---|
| 1 | IFRS Adp[a] | . | Enter |

a. All requested variables entered.

b. Dependent Variable: Absres1

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .059[a] | .003 | .003 | .29350 |

a. Predictors: (Constant), IFRS Adp

**ANOVA[b]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | .475 | 1 | .475 | 5.518 | .019[a] |
| | Residual | 137.307 | 1594 | .086 | | |
| | Total | 137.783 | 1595 | | | |

a. Predictors: (Constant), IFRS Adp

b. Dependent Variable: Absres1

**Coefficients[a]**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | .388 | .022 | | 17.759 | .000 |
| | IFRS Adp | -.015 | .002 | -.059 | -1.391 | .089 |

a. Dependent Variable: Absres1

## Appendix 4. Autocorrelation Test

**Model Summary[b]**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Durbin-Watson |
|---|---|---|---|---|---|
| 1 | .150[a] | .022 | .022 | .48667 | 1.957 |

a. Predictors: (Constant), IFRS Adoption

b. Dependent Variable: FR Qual

## Appendix 5. Simple Linear Regression

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .150[a] | .022 | .022 | .78353 |

a. Predictors: (Constant), IFRS Adoption

**ANOVA[b]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 22.439 | 1 | 22.439 | 36.550 | .000[a] |
| | Residual | 978.597 | 1594 | .614 | | |
| | Total | 1001.036 | 1595 | | | |

a. Predictors: (Constant), IFRS Adoption

b. Dependent Variable: FR Quality

**Coefficients[a]**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | | |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | t | Sig. |
| 1 | (Constant) | 1.691 | .047 | | 35.955 | .000 |
| | IFRS Adoption | .130 | .022 | .150 | 6.046 | .010 |

a. Dependent Variable: FR Quality