

The Impact of International Financial Reporting Standards adoption on Accounting Quality: Evidence From Sri Lanka.

P.R. Weerathunga

118720F



University of Moratuwa, Sri Lanka.
Master of Science in Financial Mathematics
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

Department of Mathematics

Faculty of Engineering

University of Moratuwa

Sri Lanka

March 2015

The Impact of International Financial Reporting Standards adoption on Accounting Quality: Evidence From Sri Lanka.

P.R. Weerathunga

118720F

Thesis submitted in partial fulfillment of the requirements for the Master of Science in



University of Moratuwa, Sri Lanka.
Financial Mathematics
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

Department of Mathematics
Faculty of Engineering
University of Moratuwa
Sri Lanka

March 2015

DECLARATION OF THE CANDIDATE

I declare that this is my own work and this thesis does not incorporate without acknowledgement any material previously submitted for a Degree or Diploma in any University or other institute of higher learning and to the best of my knowledge and belief it does not contain any material previously published or written by another person except where the acknowledgement is made in the text

.....

Signature

P. R. Weerathunga

.....

Date



University of Moratuwa, Sri Lanka.
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

CERTIFICATION

I hereby recommend that the thesis titled “The Impact of International Financial Reporting Standards adoption on Accounting Quality: Evidence From Sri Lanka” prepared by Mr. P.R. Weerathunga under my supervision be accepted for the submission of the Degree of Master of Science in Financial Mathematics.

.....
Dr. K.G.A Udaya Kumara
Senior Lecturer
Department of Accountancy and Finance
Faculty of Management Studies
Rajarata University of Sri Lanka
Mihintale.

.....
Date



University of Moratuwa, Sri Lanka.
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

.....
Mr. T.M.J.A. Cooray
Senior Lecturer
Department of Mathematics
Faculty of Engineering
University of Moratuwa
Moratuwa.

.....
Date

DEDICATION

To my loving parents

Dear teachers

and all of my friends

without whom none of my success would be possible.



University of Moratuwa, Sri Lanka.
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

ACKNOWLEDGMENT

It gives me great pleasure to thank the following individuals who have made this thesis a success.

I owe a great deal to Dr. KGA Udayakumara, Senior Lecturer and Head of the Department of Accountancy and Finance, Faculty of Management Studies, Rajarata University of Sri Lanka, who agreed to supervise me throughout the period of the research. He provided me with helpful comments on the scope and methodologies of this research and the design and content of this thesis. His constructive criticism and prompt feedback on the writing up of the chapters especially for the submission of the first draft of the thesis were an invaluable asset.

Then, I indebted to Mr. TMJA Cooray, Senior Lecturer and Coordinator for M.Sc. /P.G. Diploma in Financial Mathematics of Department of Mathematics, Faculty of Engineering, University of Moratuwa, who also supervised me especially for statistical analysis of the research. His continuous support, advice and encouragement were priceless. This thesis has benefited significantly due to his criticisms and suggestions. I would also grateful to Mr. AR. Dissanayake, Senior Lecturer of Department of Mathematics, Faculty of Engineering, University of Moratuwa, for providing necessary information from the beginning of course and encouraging us to complete the course early possible.

At various times, I have received helpful discussions and constructive comments from notable individuals. My thanks go to Dr. PMB Jayathilake (Head of the Department of Business Management, Faculty of Management studies, Rajarata University of Sri Lanka), Mr. Sampath Kappagoda (Senior Lecturer, Rajarata University of Sri Lanka), Mr. KV Aruna shantha (Lecturer, Rajarata University of Sri Lanka).

A special thank goes to Mr. AADP Bandara (Lecturer, Rajarata University of Sri Lanka) for accepting part of my duties when I struggle at the deadline of the submission of this thesis.

Finally I would like to thank all the staff members at the Department of Accountancy and Finance for their support in my academic endeavors.

ABSTRACT

This study examines whether the application of International Financial Reporting Standards (IFRS/SLFRS) is associated with higher accounting quality for Sri Lankan firms using a sample of 157 firms listed Colombo Stock Exchange (CSE). The companies listed on CSE were mandated to adopt IFRS/SLFRS in preparation of their financial statements with effect from 01st of January 2012. Prior to the adoption of IFRS/ SLFRS Sri Lankan firms reported under Sri Lankan Accounting Standards (SLAS). Thus, this study compares several measures of accounting quality for Sri Lankan firms under two reporting regime to identify the improvement of accounting quality in post IFRS/SLFRS adoption. Following prior studies, this study uses eight individual measures of accounting quality relating to earnings smoothing, managing towards earnings targets, timely loss recognition and value relevance. Firms are said to have improved accounting quality if they display lower levels of earnings smoothing, less management towards earnings targets, more timely loss recognition and higher levels of value relevance. The results of this indicate that in general, accounting quality of SL firms improved after mandatory IFRS/ SLFRS adoption in terms of displaying less management towards earnings targets and more timeliness of loss recognition. However, there is no evidence that accounting quality has been improved with regards to reducing earnings smoothing and improving value relevance. In addition, the results of this study revealed that earning smoothing has increased significantly following mandatory adoption of IFRS/ SLFRS. Further, the value relevance of accounting numbers is very low under IFRS/ SLFRS.



University of Moratuwa, Sri Lanka
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

TABLE OF CONTENTS

	Page
Declaration of Candidate.....	i
Certification.....	ii
Dedication.....	iii
Acknowledgement.....	iv
Abstract.....	v
Table of Contents.....	vi
List of Figures.....	ix
List of Tables.....	x
List of abbreviation.....	xi
List of annexure.....	xii
Chapter 1: Introduction	
1.1. Introduction.....	1
1.2. Background for the Study.....	3
1.2.1. Agency Theory and Information Asymmetry.....	3
1.2.2. Accounting Standards.....	4
1.3. Problem of the Study.....	6
1.4. Research Questions.....	11
1.5 Research Objectives.....	11
1.6 Significance of the Study.....	12
1.7 Methodology.....	15
1.7.1. Introduction.....	15
1.7.2. Population and Sample Selection.....	15
1.7.3. Data and Data Collection.....	16
1.7.4. Theoretical Framework and Variable Identification.....	17
1.7.5. Statistical Tests.....	18
1.8. Chapter Outline.....	19
Chapter 2: Literature Review	
2.1. Introduction.....	20
2.2. Sri Lankan Regulation and Enforcement Mechanism.....	20
2.3. Theoretical Background.....	22
2.3.1. Incentives for Accounting Standards Setters to produce	

High Quality Accounting Standards.....	24
2.3.2. Incentives for Firms to Produce High Quality Financial Reports.....	28
2.4. Previous Literatures	35
2.4.1. Empirical Studies relating to Voluntary Adoption of IFRS.....	36
2.4.2. Empirical Studies relating to Mandatory Adoption of IFRS.....	46
2.4.2.1. Studies on Earning Management and Accounting Quality	46
2.4.2.2. Studies on Value Relevance and Accounting Quality.....	51
2.5 Chapter Summary.....	57
Chapter 3: Methodology	
3.1. Introduction.....	59
3.2. Hypotheses Development.....	60
3.2.1. Accounting Quality.....	60
3.2.1.1. Earning Management.....	61
3.2.1.2. Timely Loss Recognition.....	63
3.2.1.3. Value Relevance.....	64
3.3. Research Setting.....	66
3.4. Population and Sample.....	66
3.4.1. Data.....	69
3.5. Research Model.....	70
3.5.1. Dependent Variable.....	70
3.5.2. Independent Variables.....	70
3.5.3. Control Variables.....	71
3.5.3.1. Size.	72
3.5.3.2. Growth.....	72
3.5.3.3. Equity Issue.....	73
3.5.3.4. Debt Issue.....	73
3.5.3.5. Turnover.....	73
3.5.3.6. Cash Flow.....	74
3.5.3.7. Auditor.....	74



3.5.3.8. Closely Held Shares.....	74
3.6. Accounting Quality Metrics.....	75
3.6.1. Earning Smoothing Metrics.....	75
3.6.2. Managing Towards Earning Targets.....	79
3.6.3. Timely Loss Recognition Measures.....	80
3.6.4. Timely Loss Recognition Measures.....	81
3.6.6. Summary of Accounting Quality Metrics.....	83
3.7. Chapter Summary.....	84
Chapter 4: Data Analysis and Results	
4.1. Introduction.....	86
4.2. Descriptive Analysis.....	86
4.2.1. Relationship between Earnings and Cash Flow.....	87
4.2.2. Other Accounting Measures.....	90
4.2.3. The Market Measures.....	91
4.2.4. Control Variables.....	92
4.2.4. Test of Normality.....	93
4.2.5. Bivariate Relationship between Variables.....	94
4.3. Univariate Comparison of Test and Control Variables under IFRS (SLFRS) and SLAS.....	94
4.4. Multivariate Results and Hypotheses Testing.....	99
4.4.1. Overall Improvement in Accounting Quality.....	99
4.4.1.1. Earning Management.....	100
4.4.1.2. Timely Loss Recognition.....	106
4.4.1.3. Value Relevance.....	108
Chapter 5: Conclusion and Recommendation	
5.1. Introduction.....	115
5.2. Background of the Study.....	115
5.3. Conclusion.....	116
5.4. Limitation and Problems.....	117
5.5 Recommendation for the Future Research.....	118
Reference:.....	121
Appendix A: Test of Normality.....	135
Appendix B: White Heteroskedasticity Test.....	140

LIST OF FIGURES

	Page
Figure 1.1. Conceptual Framework.....	18
Figure 2.1. Institutional Setting for Financial Reporting in Sri Lanka.....	21
Figure 3.1. Conceptual Framework.....	60
Figure 3.2. Transition to IFRS (SLFRS) of Companies with 31 st March Year-ends.....	69



University of Moratuwa, Sri Lanka.
Electronic Theses & Dissertations
www.lib.mrt.ac.lk

LIST OF TABLES

	Page
Table 2.1. Studies on Voluntary adoption of IAS/IFRS/ UK GAAP.....	46
Table 2.2. Studies on Mandatory Adoption of IAS/IFRS/UK GAAP.....	55
Table 3.1. Sample of the Companies Available for Analysis.....	68
Table 3.2. Industry Breakdown of Companies.....	68
Table 3.3. Definition of Control Variables.....	72
Table 3.4. Summary of Accounting Quality Metrics.....	83
Table 4.1. Descriptive Statistics for Test and Control Variables.....	86
Table 4.2. Descriptive Statistics for Test Variables by year.....	87
Table 4.3. Descriptive Statistics for Control Variables	89
Table 4.4. Lilliefors and Anderson-Derling Test for Normality.....	92
Table 4.5. Correlation Coefficients for the Continuous Variables.....	94
Table 4.6. Univariate Comparison of Test and Control Variables under IFRS (SLFRS) and SLAS.....	95
Table 4.7. Frequency Statistics for dichotomous Variable under IFRS (SLFRS) and SLAS.....	97
Table 4.8. Variability of Change in Net Income.....	99
Table 4.9. Variability of Ratio of Change in Net Income over Change in Cash Flows.....	101
Table 4.10. Correlation between OCF* and ACC*.....	103
Table 4.11. Frequency of SPOS.....	104
Table 4.12. Significance of Coefficient of SPOS.....	105
Table 4.13. Frequency of LNEG.....	106
Table 4.14. Significance of Coefficient of LNEG.....	107
Table 4.15. The Association between Share Price and Accounting Information under SLAS.....	108
Table 4.16. The Association between Share Price and Accounting Information under IFRS.....	108
Table 4.17. The Association between Earnings and Return for both Good News and Bad News firms under SLAS and IFRS (SLFRS).....	109
Table 4.18. Summary of the Results of Accounting Quality Metrics.....	110

LIST OF ABBREVIATIONS

Abbreviation	Description
BVPS	Book Value Per Share
CSE	Colombo Stock Exchange
DAS	Domestic Accounting Standards
EU	European Union
FASB	Financial Accounting Standards Board
FRRP	Financial Reporting Review Panel
FSA	Financial Service Authority
GAAP	General Accepted Accounting Principles
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IFRS	International Financial Reporting Standards
LKAS	Sri Lankan Accounting Standards
MVPS	Market Value Per Share
NI	Net Income
NIPS	Net Income Per Share
OCF	Operating Cash Flows
ROA	Return on Assets
SEC	Security Exchange Commission
SL	Sri Lankan
SLFRS	Sri Lankan Financial Reporting Standards
UK	United Kingdom
US	United State



University of Moratuwa, Sri Lanka.
Electronic Theses & Dissertations
www.lib.sri.lanka.lk