



3rd International Conference on New Challenges in Management and Organization: Organization and Leadership, 2 May 2016, Dubai, UAE

Impact of IFRS on Earnings Management: Comparison of Pre-Post IFRS Era in Pakistan

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Abstract

This paper investigates the impact of introduction of International Financial Reporting Standards on earnings management of Public limited companies in Pakistan as the purpose of the reporting standards is to make the financial statements of companies more transparent and comparable. The research undertaken, is based on sampling process involving 100 Companies, listed on Karachi Stock Exchange of Pakistan, to investigate the quality of accounting information enhanced in the context of pre-post IAS/IFRS period i.e. 2001. The cut-off point is to evaluate the Earning management Score in absolute terms of Pakistani listed companies. This study relies upon the the cross-sectional modified Jones model of by Kothari et al. (2005). With this approach, discretionary accruals are measured on the past estimates of an industry. In earning management the discretionary accruals represent the employment of earnings management. This is done after subtracting the portion of non-discretionary accruals from the total value of accruals. The global practice is converging towards transitioning from GAAP to domestic IFRS. With this, in many countries the use of earnings management has significantly decreased, but this is not the case in Pakistan due to two reasons; 1) Pakistan is using the IAS/IFRS based system since its inception 2) Due to 1) the data features are in a comparable form to check the effectiveness of IFRS. However, since the onset of 2001, a decreasing trend has been observed in the using of earnings management. It renders ineffective, the conclusion that the introduction of IFRS, during the period 2001 – 2009, led to less earnings management.

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Peer-review under responsibility of the Ardabil Industrial Management Institute

Keywords: *IFRS; Earnings Management; Modified Jones Model; Pakistan*

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1. Introduction

1.1 Background

The world is at the end of convergence towards International Financial Reporting Standards (IFRS) which are high quality accounting standards for judging the *transparency* and *comparability* of financial statements in financial reporting process. All users of financial statements want a true and fair representation of information about companies in financial statements. However, under the crisis period, it is disputable whether companies present the true position to the users of financial statements to make economics decisions and for resources allocation. On the other hand the management of companies can make different accounting choices or structure business transactions to report according to intent rather than true and fair presentation. In past many big or well reputed companies in all over the world created sophisticated methods for accounting manipulations by abusing accounting and shaking the confidence of the investors and general public too, which hurt the economic activity around the world. One study 'Do accounting standards matter' points out that USA, which uses rule based accounting standards (GAAPS), could not make much difference to safeguard its companies like Enron, worldcom etc. In USA the level of Earnings management score is 2 points, out of 34 countries (1990-1999). The highest point in Austria is 28 points and in Pakistan the earning management score is 17.8 points. IFRS in financial reporting can be extended beyond the quality of financial information, out in the following terms:

- To reduce the asymmetry and Earning management which can mitigate the agency problem
- To reduce the cross-border listing requirements
- To make the local GAAPS align to IFRS that is harmonization of local accounting standards
- To make better economic decisions with the help of full disclosures in the financial reports
- To maximize the firm value
- To improve the predictive and confirmatory value of the information which is more relevant and reliable to the decision making process.

1.2 Problem Statement

In Pakistan difference of opinions exists on whether IFRS adoption makes for more transparent and comparable financial statements or not and the positive or negative impact on earnings management. This has not been empirically tested before.

1.3 Research Basis

Following research question forms the basis of research to study the impact of the introduction IFRS on earnings management: What is the trend of earnings management after adoption of IFRS and the level of earnings management observed prior to adoption of these standards, in Pakistan? The undertaken study will fulfill the following research objectives;

- To identify the practices of earnings management prior to IFRS adoption, among Pakistani companies listed in KSE (Karachi Stock Exchange).
- To explore whether EM trend of Pakistani companies after adoption of IFRS has changed.
- To compare the EM behavior of the KSE listed companies in Pakistan before and after adoption of IFRS

1.4 Significance of study

- To initiate a process of deliberation on IFRS with respect to earnings management practice in Pakistan
- To accumulate empirical evidence with reference to such trends that give rise to EM.
- To determine and share possible implications of EM practices in Pakistan, with policy formulators and research nets.

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