

Does IFRS Impact on Indonesian Financial Reporting Quality and Performance? A Case Study of Companies in Indonesia

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In 2011, IFRS was adopted in Indonesia using the convergence method. This research aims to evaluate the hypothesis that IFRS could improve accounting quality and comparability. Using the indicators of income smoothing, timely loss recognition, earnings management by modified Jones, and performances, the results are found to be different from previous research where sample companies are derived from companies with the highest market capitalisations. The sample used in this research is the companies that are consistently found in the KOMPAS100 index during 2007-2018. This finding contributes to the literature of financial reporting standards and re-evaluates whether the internationalisation of accounting standards provides the best practice for financial reporting.

Key words: *IFRS, earnings management, discretionary accruals, income smoothing, timely loss recognition, Indonesia.*

Introduction

Since its global implementation, the International Financial Reporting Standards (IFRS) have been heavily considered, primarily in regard to its' comparability and effectiveness in solving fraud. Compared to Generally Accepted Accounting Principle (GAAP), IFRS is believed to have flexibility that allows for reporting financial conditions based on value relevant principles. However, the flip side of this is that IFRS allows for financial reporting management without tight regulations, which may increase fraud risks. Therefore, studies on

the IFRS convergence are crucial to obtaining clear justifications as to whether a country's financial reporting standards can improve the reliability and accountability of financial reports. A reliable financial report can attract local and foreign (prospective) investors to get involved in the investment activities of public companies, which in turn, will advance the economic position of the country.

Theoretically, IFRS will generate a financial report that is transparent, accountable, and efficient with an emphasis on (1) the alternative elimination of the accounting judgment (e.g. pooling interest in the business joint), (2) principle-based compared to the form of transaction (e.g. the change of structure of leasing from financial to operating is viewed by the leasing principle), and (3) implementation of fair value reflecting the real economic condition of the asset, liability, and equity. However, empirical research has proven that IFRS convergence does not necessarily mean an improvement occurred. Previous research has analysed the effects of IFRS implementation towards earnings management or accounting quality (Tendeloo & Vanstraelen, 2005; Barth, et al., 2008; Kabir, et al., 2010; Chen, et al., 2010; Liu, et al., 2011; Ahmed, et al., 2013; Capkun, et al., 2016), real earnings management (Doukakis, 2014), business performance (Pășcan & Țurcaș, 2012; Tanko, 2012; Müllerová, et al., 2010), and tax pressure (Karampinis & Hevas, 2013). From this research, IFRS is found to have inconclusive results. This is due to the different condition in countries, such as economic environment, culture, law enforcement as well as the different kinds and methods of IFRS adoption (generally divided into: full adoption, convergence, and optional).

In Indonesia, research has been conducted with a casuistic focus of IFRS convergence in Indonesia in 2011 (transition) and 2012 (implementation). Cahyonowati & Ratmono (2012) evaluated whether accounting information in 2011 (in the phase of IFRS preparation) was welcomed by way of investment decisions by investors, and found that accounting information is not quite relevant for investors. Arum (2013) investigated the impact of IFRS upon earnings quality and information relevancy, and she found the existence of improvement in both earnings quality and value relevance. Other research was also conducted by Sianipar & Marsono (2013), who tried to identify the change in accounting information quality after IFRS adoption; they discovered that nothing changed. In view of all the above research, there is no consensus as to whether IFRS brings a positive or negative impact on accounting information. Therefore, a few weaknesses have been identified in the previous research and this research seeks to make solutions that contribute to the literature of IFRS convergence.

Firstly, the short time frame for the existing data (2011, 2012, and 2013) is too limited (or even irrelevant) to properly evaluate the impact of IFRS on financial reports. Secondly, the sampling selection is not adequate, choosing from only one industry does not reflect the bigger picture of the after-effects of IFRS convergence. Thirdly, the proxy measurement of

earnings quality was not comprehensive and did not wholly describe most concerns. Therefore, this research will contribute by using: (1) a longer time horizon, 2007-2018, (2) sample companies that are consistently indexed in the KOMPAS100 from 2007-2018, and (3) three different proxies of earnings quality, earnings management, income smoothing, and timely loss recognition, to try to identify whether there are improvement in companies performance.

Literature Review

Soderstrom & Sun (2007) reviewed the adoption of IFRS started from 2005. The European Union parliament, as the first collective of nations to conduct harmonisation, mandated IFRS adoption for public firms in EU countries. Even though it was not an obligation before 2005, European firms voluntarily used International Accounting Standard (IAS) as a part of their harmonisation of economic systems. This was proven by the commitment of the European Commission's (EC) to regulate: (1) the optimisation of the true and fair view (TFV) principle, to reflect the intrinsic values of operating activities and unify the format and size of balance sheets and income statements in 1978; and (2) the stipulation of reporting format related to the consolidation in 1983. They thought that the aim of the TVF principle is not only to make information more relevant and useful for stock valuation, but also to make other stakeholders more efficient in delivering work such as tax information, creditors covenant information, and job contract information.

Ball (2006) analysed the IFRS adoption in global terms. He theorised that the stages of global accounting standards begin with uniformed voluntary standards and end with uniformed mandatory standards. Companies are motivated to generate financial reports that satisfy stakeholders using self-established accounting methods. However, individually generating accounting standard is impossible due the high cost that would be incurred. Therefore, the implementation of uniformed standards is more urgent because the standard is a public commodity that has benefit *ex post* implementation. Through the implementation of standards, auditors might feasibly be able to protect stakeholders from management misbehaviour. According to Ball, this theory is in the stage of accounting standards not required, or involuntary, with weakness possibilities such as (1) different accounting practices across firms, industries, times, locations, etc., (2) the high cost of developing accounting standards, and (3) other firms not internalising the substantial amount of costs charged by firms who develop their own accounting standard. Hence, the option of voluntary adoption is not a solution to upgrade accounting reports. Ball specified that the urgency of mandatory adoption of IFRS will drop the cost of communication in international affairs due to the open market and political internationalisation. Some publications have identified positive impacts of IFRS adoption, like positive market reaction in European countries, for both countries with low or high accounting information quality (Armstrong, et al., 2010), a

significant increase in accounting quality (Chen, et al., 2010), limiting the earnings management, improving timely loss recognition and value relevancy in 21 countries (Barth, et al., 2008), reducing earnings management and increasing the quality of value relevance in China, a country with strict regulation (Liu, et al., 2011), increasing the performance of Nigeria's companies (Tanko, 2012), lessening the tax pressure in Greece (Karampinis & Hevas, 2013), and improving the liquidity of the capital market, decreasing the capital cost and significance of Tobin's q proxy in countries with serious intentions and "label only" when adopting IFRS (Daske, et al., 2013).

In Indonesia, the IFRS convergence phase started in 2008 as a form of preparation for the Indonesian government to part in the G20 forum. The convergence process was finished and fully implemented by firms in 2012. Therefore, it is estimated that the reports between 2012 and 2017 will proxy the effect of IFRS convergence in Indonesia. Previous research observed the positive impact of the decrease in earnings management and the increase in accounting information relevancy using 117 firm-year samples in Indonesia in 2010 as pre-IFRS and 2011 as post-IFRS (Arum, 2013). However, Cahyonowati & Ratmono (2012) showed that there is no significant information relevancy after IFRS in the population of public companies (excluding IPO firms) using the period of 2010-2011 as post-IFRS and 2008-2009 as pre-IFRS.

Sianipar & Marsono (2013) indicated that there is no difference in information relevancy, timely loss recognition, and earnings management for manufacturing firms in 2011 as pre-IFRS, and 2012 as post-IFRS. With these inconclusive findings, the big question is raised, "what is the benefit of IFRS?" Previous research also found that IFRS adoption did not always bring the desired results, Christensen, et al. (2015) emphasize that only internal company incentives can determine the output of IFRS adoption. They found a significant increase in quality for public companies in Germany that previously voluntarily adopted IFRS, as compared to firms believing in IFRS implementation, only when mandated by law. A study in Germany in 1999-2001 (voluntary) showed that IFRS does not bring any changes in earnings management behaviour (Tendeloo & Vanstraelen, 2005). Pășcan & Țurcaș (2012) also found that there is no increase in performance in net income after the first time adoption for companies in Romania. Kabir, et al. (2010) indicated an increase in accounting performance in public companies in New Zealand but did not find an improvement in earnings quality post-IFRS adoption. In a cross country study, income smoothing increased (Capkun, et al., 2016) and reporting become aggressive (Ahmed, et al., 2013) after IFRS adoption.

Therefore, this research intends to address the research gap as to whether IFRS can make significant improvements in terms of accounting quality and performance.

Research Method

The sample firms chosen in this study are public firms that are consistently indexed in the KOMPAS100 in IDX. This was done as this index is comprised of 100 companies that have the highest market capitalisation across nine industries. By using this index, the individual effects that come from companies in different categories can be minimised. The financial data is collected from Datastream (Worldscope). The time horizon of the data is 2007 to 2018, with 2007-2011 as pre-convergence, 2012-2018 as post-convergence, and special attention on 2011 as a transition period. This research excludes companies in financial sectors due to the difference in general earnings quality and performance measurements. Table 1 below described the number of companies used in this research.

Table 1: Number of Sample Firms Used

Companies	Total
Number of companies in KOMPAS100 index	100
Companies that are not consistently indexed in KOMPAS100	73
Companies consistently indexed in KOMPAS100	27
Finance companies consistently indexed in KOMPAS100	3
Companies consistently indexed in KOMPAS100 (without finance companies)	24

Earnings management behaviour is measured by the proxies of income smoothing, timely loss recognition, and abnormal accruals. This research capitalises on the measurement of income smoothing model by Ahmed, et al. (2013) and is depicted in Equation 1 and Equation 2 below:

Equation 1. Income Smoothing from Change in Net Income Model (Ahmed, et al., 2013)

$$\Delta NI_{it} = \alpha + \beta_1 IFRS_{it} + \beta_2 BTM_{it} + \beta_3 Growth_{it} + \beta_4 Eissue_{it} + \beta_5 Lev_{it} + \beta_6 Dissue_{it} + \beta_7 Turn_{it} + \beta_8 Size_{it} + \beta_9 CashFlow_{it} + \beta_{10} Industry_{it} + \varepsilon$$

Equation 2. Income Smoothing from Change in Cash flow Operational Model (Ahmed, et al., 2013)

$$\Delta CF_{it} = \alpha + \beta_1 IFRS_{it} + \beta_2 BTM_{it} + \beta_3 Growth_{it} + \beta_4 Eissue_{it} + \beta_5 Lev_{it} + \beta_6 Dissue_{it} + \beta_7 Turn_{it} + \beta_8 Size_{it} + \beta_9 Industry_{it} + \varepsilon$$

Where:

ΔNI_{it} = change in net income, divided by total asset current year

ΔCF_{it} = change in cash flow operational, divided by total asset current year

IFRS _{it}	= dummy variable 1 if year ≥ 2012 and 0 if year < 2011
BTM _{it}	= ratio of book to market
Growth _{it}	= percentage of change in sales
Turn _{it}	= sales divided by total asset current year
Eissue _{it}	= change of common stock, in percentage
Lev _{it}	= ratio of total liabilities divided by book value
Dissue _{it}	= change of total liability, in percentage
Size _{it}	= natural logarithm of total asset
CashFlow _{it}	= cash flow operational divided by total asset current year
Industry _{it}	= nine dummy industries in Indonesia

To measure the income smoothing, the variance of the residue of change in net income from Equation 1 (ΔNI_{it}^*) and the variance ratio between residues from change in net income and residues from change in cash flow operational ($\Delta NI_{it}^*/\Delta CF_{it}^*$), are measured. The significant increase of the measurement implies a decrease in income smoothing.

Another measurement is timely loss recognition, drawn from the model by Ball & Shivakumar (2005), with a concern on the coefficient β_7 interpreting and increase in conservatism if coefficient β_7 significantly increases as described in Equation 3 below:

Equation 3. Timely Loss Recognition (Ball & Shivakumar, 2005)

$$\Delta NI_{it} = \alpha + \beta_1 D\Delta NI_{it-1} + \beta_2 \Delta NI_{it-1} + \beta_3 D\Delta NI_{it-1} * \Delta NI_{it-1} + \beta_4 IFRS_{it} + \beta_5 IFRS_{it} * D\Delta NI_{it-1} + \beta_6 IFRS_{it} * \Delta NI_{it-1} + \beta_7 IFRS_{it} * D\Delta NI_{it-1} * \Delta NI_{it-1} + \beta_8 Control_{it} + \varepsilon$$

Where:

$D\Delta NI_{it-1}$ = dummy variable 1 if last year change in net income < 0, and 0 otherwise

The final measurement is the abnormal accruals model of modified Jones (Dechow, et al., 1995). From this model, the error (ε) term is the proxy of abnormal accruals that cannot be defined by the variability of the independent variables in the model. The abnormal accruals model is defined in Equation 4 below:

Equation 4. Abnormal Accruals Model of Jones Modified (Dechow, et al., 1995)

$$ACC_{it} = \alpha + \beta_1 (\Delta Rev_{it} - \Delta Rec_{it}) + \beta_2 PPE_{it} + \beta_3 \left(\frac{1}{Assets_{it}} \right) + \varepsilon$$

Where:

ACC_{it} = total accruals, by subtracting cash flow operational current year from net income current year, divided by total asset current year

$\Delta Rev_{it} - \Delta Rec_{it}$ = change in sales/revenues minus change in receivable current year,
divided
by total asset current year
 PPE_{it} = gross value of property, plant and equipment of current year, divided by
total asset current year
 $Assets_{it}$ = total asset current year

To test whether the IFRS has an impact on earnings management, the model in Equation 5 is used:

Equation 5. Equation Model to Test Correlation between IFRS and Abnormal Accruals

$$DACC_{it} = \alpha + \beta_1 IFRS_{it} + \beta_2 Control_{it} + \beta_3 Industry_{it} + \varepsilon$$

Where:

$DACC_{it}$ = discretionary accruals, the predicted error term from the model from Equation 4.

This research uses the ratios of return on asset, return on equity, book-to-market, growth, and turnover as well as size, to evaluate the performance companies (Pășcan & Țurcaș, 2012; Kabir, et al., 2010). Equation 6 describes the model used to study the correlation between performance and IFRS:

Equation 6. Equation Model to Test Correlation between IFRS and Performance

$$Y_{it} = \alpha + \beta_1 IFRS_{it} + \beta_2 Control_{it} + \beta_3 Industry_{it} + \varepsilon$$

Where:

Y_{it} = different measurements of company performance

Result and Discussion

Table 2 presents the descriptive statistics to be used in the analysis in this research. All variables were employed in the four analyses of income smoothing, timely loss recognition, earnings management, and financial performance. From the table, BTM has the highest standard deviation due to the lack of market value compared to book values of companies. However, it has been winsorized at a 10% level to minimise the effect of the abnormality on the data.

Table 2: Descriptive Statistics for Variables Deployed

Variables	Pre-IFRS (n=96)		Post-IFRS (n=168)	
	Mean	Std. Deviation	Mean	Std. Deviation
Δ NI	0.0087	0.1334	-0.0171	0.0878
Δ CF	-0.0102	0.1214	-0.0087	0.0691
ACC	<-0.0001	0.1149	<-0.0001	0.0845
BTM	414.4100	304.2652	457.9948	319.0740
Growth	0.1479	0.2411	0.0805	0.1868
Turn	0.9761	0.5913	0.7855	0.4894
Eissue	0.0110	0.1516	0.0207	0.1461
Lev	1.0490	0.8295	1.1500	0.7746
Dissue	0.2129	1.0898	0.1438	0.2118
Size	22.9504	2.1467	23.3651	2.6322
CashFlow	0.1624	0.1209	0.1132	0.1047
Δ Rev - Δ Rec	-0.0117	0.1719	-0.0281	0.1153
PPE	0.6629	0.5401	0.7035	0.5663
1/Assets	<0.0001	<0.0001	<0.0001	<0.0001

Note: All variables are as defined in previous section. BTM is winsorised at 10%

Table 3 shows a decrease in the measurement, which indicates that after IFRS convergence, firms had less incentives to smooth earnings. This finding differs from Ahmed, et al. (2013), indicating that IFRS brings improvement in terms of lowering the motivations to manipulate earnings. Moreover, this finding is also different when compared to previous research in Indonesia (Arum, 2013).

Table 3: Result of Income Smoothing Measurements

	Var Δ NI*	Var Δ NI* / Var Δ CF*
Pre-IFRS (n = 96)	0.0101	0.0879
Post-IFRS (n = 168)	0.0049	0.0580
Difference	0.0052	0.0299
<i>p</i> -value pre \neq post	0.0000***	0.0000***
<i>p</i> -value pre > post	0.0000***	0.0000***

Note: The error terms of Δ NI* and Δ CF* are generated from the Equation 1 and 2 after controlling the effect of industry and time. The *p*-value is the result of the variance ratio test.

Table 4 depicts that the coefficient in β_7 (coefficient from the interaction variable of IFRS * ΔNI_{it-1} * ΔNI_{it-1}) indicated that timely loss recognition increased after IFRS. This result is dissimilar with previous research in Indonesia (Arum, 2013; Sianipar & Marsono, 2013).

Table 4: Result of Timely Loss Recognition

ΔNI_{it} (n = 240)	Test 1	Test 2	Test 3	Test 4
$D\Delta NI_{it-1}$	0.0677***	.0711***	0.0671***	0.0706***
ΔNI_{it-1}	-0.1127	-0.0874	-0.0685	-0.0064
$D\Delta NI_{it-1} * \Delta NI_{it-1}$	0.4889*	0.3819	0.3424	0.2533
IFRS _{it}	0.0001	0.0064	0.0048	0.0414
IFRS * $D\Delta NI_{it-1}$	-0.0807***	-0.0766***	-0.0685**	-0.0742***
IFRS * ΔNI_{it-1}	-0.8928***	-0.9089***	-0.9642***	-1.0129***
IFRS * $D\Delta NI_{it-1}$ * ΔNI_{it-1}	0.5534*	0.6302**	0.7435**	0.7936**
BTM _{it}	-	<0.0001	<0.0001	<-0.0001
Growth _{it}	-	0.1189***	0.1160***	0.1211***
Turn _{it}	-	0.0173*	0.0162	0.0170
Size _{it}	-	-0.0014	-0.0011	-0.0012
Fixed Effect 1	-	-	Industry	Industry
Fixed Effect 2	-	-	-	Year
Constanta	0.0059	0.0022	-0.0159	-0.0337
F-stat	28.30	21.97	13.87	9.87
Prob > F	0.0000	0.0000	0.0000	0.0000
Adj.R ²	0.4443	0.4912	0.4922	0.4911

Note: All variables are as defined in previous section. Industries in this data are (1) agriculture, (2) mining, (3) basic industry and chemicals, (4) miscellaneous, (5) consumer goods, (6) property, real estate and building construction, (7) trade, services, and investment. *** significant at 1% level, ** significant at 5% level, *significant at 10% level.

Table 5 shows that IFRS has no effect on discretionary accruals in terms of: real values, absolute values, negative earnings management (conservatism), and positive earnings management (aggressive). This finding is similar with that of Sianipar & Marsono (2013), but different from Arum (2013).

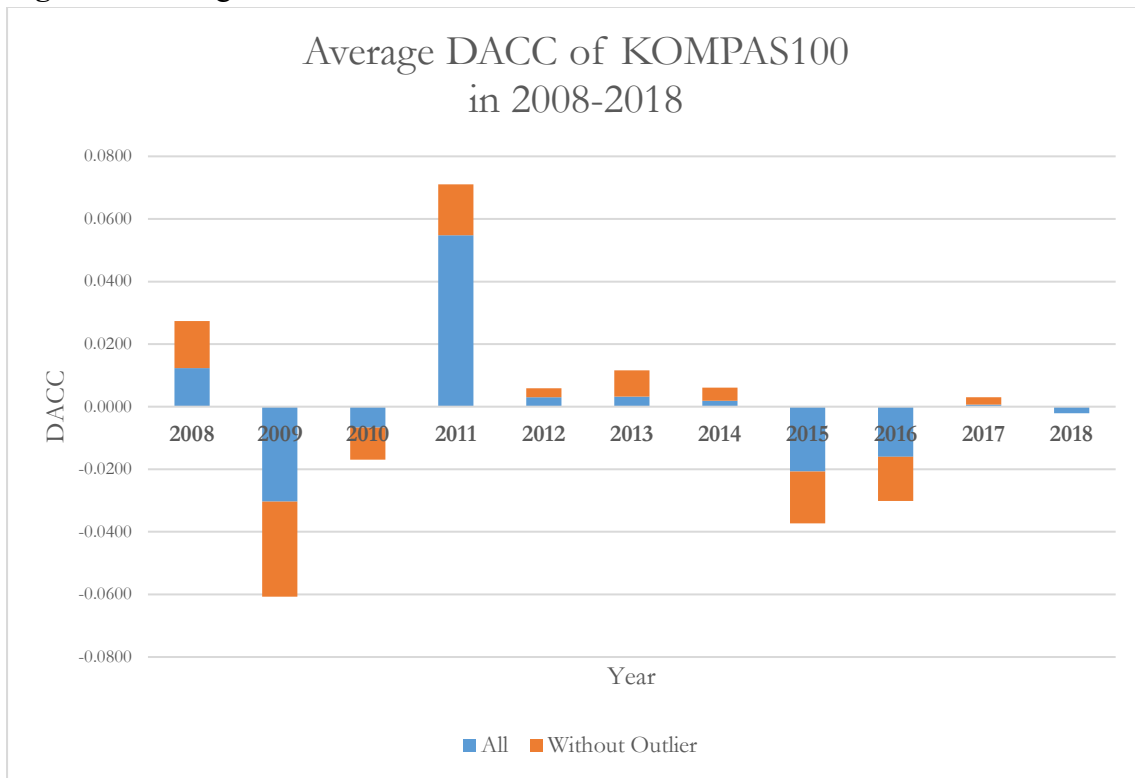
Table 5: Result of Earnings Management

	DACC n = 264	DACC n = 264	DACC < 0 n = 152	DACC > 0 n = 112

IFRS	0.0010	-0.0116	0.0081	-0.0053
BTM	0.0000	<-0.0001	<0.0001	<-0.0001
Growth	0.0508*	0.0142	0.0112	0.0192
Turn	0.0344**	0.0238**	-0.0003	0.0558**
Size	-0.0015	0.0053**	-0.0044***	0.0054
Fixed Effect 1	Industry	Industry	Industry	Industry
Fixed Effect 2	Year	Year	Year	Year
Constanta	0.0098	-0.1159**	0.0844**	-0.1614
F-stat	2.99	2.97	3.43	1.73
Prob > F	0.0000	0.0000	0.0000	0.0401
Adj.R ²	0.1368	0.1357	0.2530	0.1214
Note: All variables are as defined in previous section. *** significant at 1% level, ** significant at 5% level, *significant at 10% level.				

Figure 1 below indicates that abnormal accruals peaked in 2011, even after the outlier firm was deducted. Empirically, the test of difference revealed that there is no significant difference in abnormal accruals between pre- and post-IFRS.

Figure 1. Average DACC of KOMPAS100 in 2008-2018



Source: Data is processed individually, after conducting tests of differences between pre- and post-IFRS, it is revealed that there is no significant difference.

Table 6 illustrates that IFRS has a negative effect on performance. This is in contrast with previous result that stated that IFRS adoption has no indicative effect on performance (Pășcan & Țurcaș, 2012).

Table 6: Result of Performance Measurement

Performance n = 264	Growth	Turn	Size	ROA	ROE
IFRS	-0.1229**	-0.2396**	0.6233	- 0.0602**	-0.0773
Fixed Effect 1	Industry	Industry	Industry	Industry	Industry
Fixed Effect 2	Year	Year	Year	Year	Year
Constanta	0.2209***	1.0547***	25.6982** *	0.1146** *	0.2361** *
F-stat	3.26	13.67	4.36	8.25	5.24
Prob > F	0.0000	0.0000	0.0000	0.0000	0.0000

Adj.R ²	0.1211	0.4352	0.1698	0.3060	0.2050
Note: All variables are as defined in previous section. *** significant at 1% level, ** significant at 5% level, *significant at 10% level.					

This research brings up discussion as to whether IFRS convergence could lead to a higher quality of financial reporting. On one hand, IFRS is an effort to standardise reporting mechanisms and recording transactions that are viewed using principle bases. On the other hand, it is argued that improvement in reporting quality is not dependent on accounting standards, rather it is on country specific measures, for example: economic conditions, internal and geo-political assurances, law enforcement, cultural differences, etc.

In Indonesia, IFRS has been progressively implemented for eight years (2011-2019), and there are no conclusive notions, in any perspectives, as to whether IFRS has brought about positive effects. Rather, the results in this study revealed that the companies tend to recognise loss timelier and their performance declines. The only negative pattern declining is earnings smoothing. This indicates that maybe the government should look for other ways to make accounting reporting higher quality, i.e corporate governance mechanisms.

The results of this research are indicative after limiting the effect of variability in company size and performance and after covering a longer time in the aftermath of the IFRS convergence effect. However, further research should implement other indicators of earnings quality such as real earnings management. They should also pay attention to the samples employed; it is suggested to deploy the population of IDX to obtain a greater picture of the convergence effect. Also, the ways of evaluating industry-specific earnings management should be further developed in order to capture the different earnings management behaviour after IFRS.

Conclusion

The results indicated that: (1) earnings smoothing decreased, (2) timely loss recognition increased, (3) earnings management has no effect, and (4) performance decreased after converging into IFRS. The results are robust for companies indexed in the KOMPAS100.

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