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IFRS Adoption and Earnings Quality in Jordan

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Abstract

The motivation of this study is that compliance with regulations and requirements of financial reporting is quite low in the Arab capital market. Also, most of the studies that have investigated IFRS adoption and earnings quality have been in developed markets leaving for a dearth of literature from developing markets like Jordan. It is on this note that this study addresses the relationship between IFRS adoption and earnings quality by critically examining the literature and highlighting the current state of this relationship. The study also provided an explanation for this link between IFRS adoption and earnings quality using the legitimacy theory. It was observed from the literature that two contrasting views come up canvassing for and also refuting the adoption of IFRS and its use by developing countries like Jordan. The legitimacy theory provided an explanation for a positive relationship between IFRS adoption and earnings quality. Following the concerns raised as to how appropriate IFRS would be for the Jordanian environment faced with several institutional weaknesses, it is recommended that the Jordanian government join forces with other governments within the GCC countries to develop a regional accounting standard body that would take into consideration the peculiarity of the specific environment.

Keywords: Accounting; Earnings quality; Regulations; Legitimacy theory; Jordan.

Introduction

Accounting information plays an important role in the success or failure of any organisation, as it can aid firms in the management of problematic areas such as costing, and cash flow which provides useful information for monitoring and control (Mitchell, Reid & Smith, 2000; Son, Marriot & Marriot, 2006). The role of accounting information for all companies looking to acquire funds from the financial markets cannot be overemphasised. Market participants respond positively to high quality accounting information, as it helps to bridge the information asymmetry and overall transparency of the firm (Watts & Zimmerman, 1986). As a result of the importance of the accounting information, it is therefore necessary that organisations ensure that the information is of high quality.

Jordan Accounting Framework (2004) categorise the fundamental qualitative characteristics of accounting information to include understand ability, relevance, reliability, and comparability.

Consistent with these characteristics and growing literature, this study investigates accounting information quality by interpreting accounting quality using the value relevance, earnings persistence, timely loss recognition and lastly earnings management models.

Accounting information, which is the end product of the financial reporting process not only represents corporate financial and non-financial information required by regulators which firms have to deal with, but also can be used as a medium to communicate between the firm and related parties, i.e creditors, investors and analysts. Financial information shown on the corporate report is thus of interest to stakeholders and can affect the users who rely on this information. Right from the early study of Ball and Brown (1968) that examined the association between accounting numbers and share price, a great deal of researchers have focussed attention in investigating whether financial reporting provides useful information for stakeholders in terms of decision making and predictability. Specifically, as reported by a growing amount of accounting literature in the area of financial reporting, recent research studies around the world have focused on and been aware of the quality of accounting information disclosed on the corporate financial report (Ball & Shivakumar, 2005; Prather & Kinsey, 2006). A number of studies have also shown that higher accounting quality is associated with lower cost of equity and debt (Francis, Lafund, Olsson & Schipper, 2004).
As a way of improving the quality of earnings and by extension the overall accounting information quality. The International Financial Reporting Standards have been adduced as a way to achieving this improved earnings. In 1997, the Jordanian government began an aggressive program on privatization. To ensure the program strives, Jordan enacted the 1997 Company Law, and the 2002 Securities Law. These laws were the bedrock for the introduction of IFRSs and its enforcement. Prior to these laws, accounting practice in Jordan dates as far back as the 8th century. It was basically with no format or content for financial statement (Al-Akra, Ali & Marashdeh, 2009). Further, the first regulations on accounting emerged in the 1960s and it was very limited. In addition, at the time there was absence of an accounting standard setting body (Al-Akra, Eddie & Ali, 2010). The procedures laid down for regulating the practice of accounting was entirely done by the government through the Ministry of Industry and Trade. The Company laws, were basically enacted to enforce IFRSs, making it compulsory, and non-compliance illegal. The laws also set in motion the Jordanian governance framework which emphasized the board of directors' responsibilities in ensuring compliance with these requirements.

Previous studies have documented that substantial change in accounting standards can substantially influence earnings quality (Ashbaugh & Pincus, 2001; Gornik-Tomaszewski, 2001; Giner & Rees, 1999; Hellstrom, 2006; Prather-Kinsey, 2006). In the event of the aftermath of the integration of global capital market, there has been an increasing demand for internationally acceptable accounting information that cuts across boundaries. This has made IFRS spread quickly among countries. The early 2000s saw a number of countries opting for a unified global accounting harmonization policy. The European Union in 2002 under the 1606/2002 regulation made it compulsory for the use of IFRS within the Union in financial reporting of listed companies for the accounting year beginning on 1st January 2005.

Following the adoption of IFRS by the European Union, several other countries have followed suit. In October 2003, the Financial Reporting Council of Australia encouraged the boards of companies and their managers to set up preparations early enough for IFRS adoption in Australia. In 2013, according to an IFRS foundation survey aimed at centralizing information for measuring strides made by each region, the results revealed that out of a sample of 66 countries surveyed, 80% appeared to have IFRS already in place for its public companies and most of the remaining apparently had started making progress in that direction. In 2007, mandatory compliance was made compulsory in China (Cho, Kwon, Yi & Yun, 2015). Rammana (2012) add that IFRS is one of the most important developments in corporate governance and as at 2010; over 100 countries have either adopted or have initiated concrete plans to adopt.

IFRS takes into consideration the investors as the main group relying on the financial report (IASC, 2012). This is referred to as the principle system (Atwood, Drake, Myers & Myers, 2011; Carmona & Trombetta, 2008; Chen, Tang, Jiang & Lin, 2010; IASB, 2012), which is designed to enforce a transparent financial system to enthrone an overall transparent company that will enhance the value of the accounting system. In addition, Daske, Hail, Leuz and Verdi (2013) assert that most of the literature on differences in economic consequences following IFRS adoption has been based on institutional differences across countries, and tend to focus on the average effect of these adoptions with respect to some outcome variables at the country-level. They further argue that the application of IFRS requires the use of expert judgment providing firms with a wide window of discretion. However, the manner in which firms leverage the use of this discretion depends on their willingness for financial reporting transparency. Previous studies have highlighted that the result of IFRS adoption might be dampened by the incentives beyond management's reporting and the corporate governance structure in place (Christensen, Lee & Walker, 2007; Daske et al., 2013; Zeghai, Chtaurou & Sellami, 2011). Proponents of IFRS have made claims that the adoption of IFRS by an entity leads to a higher quality of disclosures by that organization. Abu-risheh and Alsaeed (2014) assert that the adoption of IFRS in the Jordanian environment have increased the complexity of financial reporting and there is indeed the tendency for misreporting, if those responsible for preparing the financial statements and the auditors do not have the required IFRS expertise makes for a timely and efficient reporting of economic gains and losses (Barth, Landsman & Lang, 2008).
The general motivation of the study as has been highlighted in many studies on standards and regulations is that compliance with regulations and requirements is quite low in the Arab capital markets (Solas, 1994). For instance, Haddad, AlShattarat, AbuGhazaleh and Nobanee, (2015) assert that the level of compliance with voluntary information in Jordan is about 24%. The reasons for such abysmal compliance levels in these financial markets may be attributable to loopholes in financial regulations and audit guidelines, the high cost of compliance, lack of understanding of financial legislation and standards, most especially IFRS and the inefficiency of regulatory bodies (e.g. Owusu-Ansah & Yeoh 2005; Tai, Au-Yeung, Kwok & Lau, 1990; Saudagaran & Diga, 1997). In the light of the numerous benefits associated with such standards, poor compliance obviously will not do such society any good. Also, while most of the studies that have investigated IFRS adoption and earnings quality have been in developed markets in Europe (Callao, Jarne & Lainez, 2007; Ernstberger & Vogler, 2008; Paananen & Lin, 2009), Australia (Goodwin, Ahmed &

Heaney, 2008; Jeanjean & Stolowy, 2008), there is a dearth of literature from Jordan and when the differences between both sets of markets in terms of institutional, organisational and regulatory frameworks are taking into consideration it thus provides a void that needs to be filled. It is on this note that this study addresses the relationship between IFRS adoption and earnings quality by critically examining the literature and highlighting the current state of this relationship. The study also exposes the implications for theory and practice as well as recommendations going forward in such an economy. The rest of the paper is organised as follows. The following section discusses the literature review, following that is the discussions section and lastly is the conclusion section.

Literature Review

International Financial Reporting Standards (IFRS)

Following the globalization of international financial markets, the position of presenting a common language for financial reporting to develop international comparability has become widespread. One of the essential characteristics that financial information must possess is comparability (IASB, 2008). Advocates of IFRS have posited that comparability can be guaranteed when IFRS is made mandatory. There is also a ripple effect of such adoption on the global investors as such comparability reduces the information acquisition costs thereby aiding investments in foreign firms (Kang & Stulz, 1997). There have also been arguments that a shared set of standards would make it easier to compare the financial performance of companies across different countries. This would enhance the effectiveness of competition for international funds and make international capital markets more efficient, leading to a lower cost of capital for firms (Jeanjean & Stolowy, 2008).

The major difference in accounting standards as a fall out of the adoption of IFRS lies in the use of fair value accounting. This can clearly be seen in standards that are related to share-based payments (IFRS2), business combination (IFRS3), property, plant and equipment (IFRS 16), impairment of assets (IFRS 36), intangible assets (IFRS 38) and investment properties (IFRS 40). This major move towards fair value accounting from the traditional historical-cost accounting presents for financial statements that are more relevant, timely, credible and transparent (Alzoubi & Selamat, 2010). This is adduced from the fact that fair values often reflect market value or something not far from it. Also in arriving at fair value, more persons such as managers and financial analysts are brought into the picture as against relying solely on the judgement of the accountant. All estimates and judgement decisions made in arriving at the fair value have to be properly justified and disclosed accordingly.

Another striking attribute of IFRS as against the traditional standards is the level of disclosure that comes with it making it difficult for those preparing the statements to carry out shady practices. For instance, IFRS 36 on impairment of assets requires more disclosure on goodwill and other intangibles, particularly in relation to how goodwill is assigned to cash generating units as well as the assumptions in measuring recoverable amounts and impairments testing.

Earnings Quality

The issue of earnings quality although has been in existence over many years only gained recognition in recent times. The contracting-based theory of accounting states that managers either efficiently report accounting earnings to maximize a firm's value for all shareholders or they opportunistically manage earnings for private gains at the cost of other shareholders (Christie & Zimmerman, 1994). Managerial opportunism indeed has been attributed as one of the main deterrence to earnings quality (Wang, 2006). Ball, Robin and Wu (2003) posit that the benefits to be derived by those whose responsibility it is to prepare the financial statement is sacrosanct to high-quality at the end of the financial reporting process. Extending this argument, Ball and Shivakumar (2005) posits that the demand by the market drives the quality of earnings. Their arguments were backed by evidence from firms in the UK. They opine that private firms operating in the UK market failed to recognise losses as timely as their counterparts in the public market. They conclude that earnings of public firms are of higher quality considering the market demands higher earnings quality from public firms than it does from private firms. Furthermore, Dechow, Ge and Schrand (2009) assert that higher earnings quality more faithfully represent the features of the firm's fundamental earning process that are relevant to a specific decision made by a specific decision-maker. The definition implies that the term earnings quality is meaningless without specifying the decision context, because the relevant features of the firm's fundamental earning process differ across decisions and decision makers.

On the issue of how earnings quality can be measured, there is no single measure of earnings quality available in the existing literature. Several proxies are however evident in the literature such as abnormal accruals, earnings informativeness, and persistence of transitory loss components in earnings (Wang, 2006). The absolute value of abnormal accruals is based on the works of Dechow and Dichev (2002) and Ball and Shivakumar (2005). Earnings quality is seen as been lower when actual accruals deviate from expected accruals in the light of the underlying economic conditions. Greater earnings informativeness basically means that earnings are of higher quality. The measure has been used by a number of studies as a market measure of earnings quality (Fan & Wong, 2002; Francis, Schipper & Vincent, 2005). On the part of transitory loss components in earnings. Earnings could be said to be of high quality when such earnings are conservative. This invariably means that the transitory loss components in earnings are less persistent than the transitory gain components (Ball, Kothari & Robin, 2000; Ball & Shivakumar, 2005).

Another measure of earnings quality prevalent in the literature is the earnings persistence model. A considerable number of studies provide evidence on the ability of reported earnings and various components of earnings, to predict future cash flows relative to cash flows from other earnings metrics. Penman and Zhang (2002) for example, show that expensing costs that have future benefits will lead to higher future earnings as the future benefits are realized in earnings, but the slowing of these expensed investments can lead to transitory boost in earnings. As a consequence, increases in capitalized investments will likely lead to errors such that the currently observed return on assets is not sustainable. Lev and Sougiannis (1996) suggest that the expensing of R&D can lead to an earnings stream that does not reflect growth in the fundamental earnings process. In summary, while we may be able to characterize earnings persistence and conclude that firms with more persistent earnings have more accurate equity valuations, which implies greater decision usefulness, we have relatively less to say about the importance of the measurement process in reaching these conclusions. By clarifying and distinguishing between fundamentals and the accounting measurement system, more insights could be obtained about the role of the measurement system itself.

Another popular measure from the literature is the concept of earnings smoothness. The literature has examined the use of discretionary accruals to artificially smooth earnings. It suggests that smoothing is value-relevant rather than opportunistic (Subramanyam, 1996; Tucker & Zarowin, 2006). There is little research that attempts to ascertain the normal component of smoothness that results from unbiased application of an accrual process to the firm's unobservable fundamental earning process. Some studies have had to benchmark earnings smoothness against the smoothness of operating cash flows (e.g Leuz, Nanda & Wysocki, 2003). In this settings, the cross-sectional variation in the discretionary component of smoothness may dominate the measurement error in the fundamental component of smoothness which makes the abnormal smoothness measure a reasonable proxy for earnings management.

The last measure considered in this paper is the issue of timely loss recognition. This measure goes straight to the point when we consider the distinction between the quality of the fundamental earnings process and the ability of the accounting system to measure the process (Dechow, Myers & Shakespeare, 2010). Differences in timely loss recognition within countries with the same standards or legal origin suggest that timely loss recognition has an endogenous component related to firms reporting incentives as it is not driven by a country's accounting system. Proxies for asymmetric timeliness based on the tendency of accruals to reverse avoids the problems associated with returns based metrics (Basu, 1997; Ball & Shivakumar, 2005). Similar to the concern raised about accrual models, this attempt to control for the fundamental earnings process is based on reported accrual earnings associated with the process.

IFRS and earnings quality

The issues of IFRS and earnings quality are a subject of debate among academics and practitioners. There are arguments that such adoption of IFRS brings about a significant improvement in earnings quality, but there are also arguments to the contrary. Proponents of the view that adoption of IFRS reporting leads to significant benefits in terms of accounting quality often start from the premise that IFRS reporting increases transparency and increases the comparability of financial reporting. The European Commission for instance, provides that the establishment of a single set of internationally accepted high quality financial reporting standards compared to many different local standards in force leads to the harmonization of firms listed on financial markets. It also leads to the efficient and cost-effective functioning of the capital market, which will protect investors by maintaining confidence in the financial markets, which would then reduce the cost of capital for firms in the EU. Lastly, it would increase the overall global competitiveness of firms within the EU and thereby improve the EU economy. Latridis (2008) in line with the argument above found a decrease in earnings management in the United Kingdom post IFRS. Similarly, Zhou, Xiong and Ganguli (2009) found a decrease in earnings management in Chinese firms, while Morais and Curto (2008) found similar results from Portuguese firms.

IFRS being introduced would reduce costs associated with the process and interpreting of accounting information and thus could enhance external monitoring of the accounting choices of firms which again will foster the earnings quality. There are also position papers that IFRS leads to improvements in earnings quality from the point of view that IFRS are considered to be principles-based and thus are potentially more difficult to circumvent than other traditional rules based standards (Armstrong, Barth, Jagolinzer, & Riedl, 2010; Barth et al., 2008). It is believed that management will find it difficult to organise transactions in a particular way to meet their targets when their decisions are assessed based on a given principle instead of a given rule. Also, the choices available to the management are reduced when IFRS is in use thus limiting the chances of misuse through discretion over alternatives. Contrarily, Jeanjean and Stolowy (2008) analysed the effect of mandatory introduction of IFRS standards on earnings quality and more precisely on earnings management, concentrating on three first time adopters, namely Australia, France and the UK. Their results suggest that pervasiveness of earnings management did not decline after the introduction of IFRS, and in fact increased in France confirming that sharing rules is not a sufficient condition to create a common business language and that management incentives and national institutional factors play an important role in framing financial reporting characteristic.

Although the literature on IFRS adoption and earnings quality from an emerging market like Jordan is scanty, there are however a few studies. Umobong and Akani (2015) provide evidence from Nigeria, one of the biggest developing countries in terms of population. The paper investigates the differences in the quality of earnings Pre and Post IFRS adoption by manufacturing firms over a five-year period. The results indicate a decline in earnings quality using earnings management, value relevance and timely loss recognition as independent variables. Also it was observed that earnings and book value of equity are less value relevant and timely loss recognition is less in post-IFRS compared to pre-IFRS period.

Discussions

There is no doubt as is evident in the literature that IFRS poses several benefits that enhances the quality of financial reporting, most specifically in terms of the quality of earnings. The push for IFRS is further heightened by the influx of investors, both local and foreign, coupled with the international audit firms operating and the need for convergence in other to ensure comparability. Firms experiencing a positive shock to their growth opportunities will need to cash in on this and raise external capital. To guide against adverse selection problem, firms in this category will need to increase their public disclosure. As a consequence, lenders can better access borrower credit quality, incur lower monitoring and re-contracting costs, and thus charge lower borrowing rates (Bassemir, 2018; Kim, Tsui & Yi, 2011).

Further IFRS enhances reporting quality especially for large firms with a greater network of subsidiaries, wider geographical dispersion of a firm's operations, foreign subsidiaries, foreign suppliers and customers (Dedman, Kausar & Lennox, 2014). Firms can manage such demands by switching from traditional GAAP to IFRS. However convincing, there are still fears expressed by several quarters such as Jordanian preparers, users and auditors that not all the IFRSs might be suitable for the Jordanian environment being a developing country with several institutional weaknesses. Also there appeared to have been a rush in the process of adoption of IFRS by the regulatory authorities in Jordan without taking advantage of the past experiences of other developing countries that had hitherto faced challenges. In preparing the first IFRS consolidated financial statements, firms had to set up an IFRS project team, adjust their software and accounting system, familiarize their staff with IFRS and intensify communication with their subsidiaries (Bassemir, 2018). Also, an IFRS reporting strategy can also impose indirect costs on firms in particular proprietary costs. The argument is that IFRS requires more extensive disclosures potentially revealing proprietary information which can be used by other parties such as competitors to the detriment of the firm (Verrecchia, 2001). All these proved major challenge to a number of firms within the Jordanian market making compliance a herculean task. It is indeed noticed that the Jordanian regulatory authority adopted IFRSs in order to provide the legal authority to ensure the achievement of higher reliability of published financial information.

Having discussed IFRS and earnings quality extensively, it is important to note that earnings quality is not only determined by IFRS adoption. Earnings quality is also partly determined by the incentives firms have to provide high-quality financial statements. There is evidence that firms dependence on external capital increases their incentives to report high-quality accounting information and to provide more useful financial disclosures (Christensen, Lee & Walker, 2007). Also, several institutional factors could also play a part in influencing firm’s reporting incentives in relation to the demand for external capital (Jeanjean & Stolowy, 2008). For instance, an economy driven by the manufacturing sector is associated with higher growth opportunities and greater competition for external capital than their counterparts in other industries. Thus if IFRS enables firms to be improve financial reporting to entice external investors, this effect would be expected to be greater in the manufacturing sector (Umobong & Akani, 2015). In summanry, the implication of our discussion for practitioners in Jordan and other developing countries sharing similar characteristics is that the adoption of IFRS does not automatically translate to higher quality accounting. This is consistent with the idea that management incentives and institutional factors play an important role in framing financial reporting characteristics, probably more important than accounting standards alone.

Conclusion

This study set out to examine the literature on IFRS adoption and earnings quality with a view to highlighting how well companies have fared subsequent to adoption. A number of studies relating to earnings quality and IFRS have been reviewed. Two contrasting views come up canvassing for and also refuting the adoption of IFRS and its use by developing countries like Jordan. It can also be seen from the studies examined that earnings quality is one of the most utilised variable in reaching decisions about the performance of firms, credit and investment decisions as well as the overall quality of financial reporting. Also brewing from the literature is the several measures that have been used to capture the quality of earnings such as the earnings persistence, earnings smoothness and timely loss recognition models. The study also looked at the possible link between IFRS disclosures and earnings quality from the point of view of the legitimacy theory that argues that firms need to follow the expectations of the society including the regulators in order to legitimize its presence and improve its earnings, rather than having to result to manipulation of its earnings, hence the theory poses that a positive relationship does exist between the adoption of IFRS and earnings quality.

Following some of the concerns raised as to how appropriate IFRSs would be for the Jordanian environment faced with several institutional weaknesses peculiar to most developing countries. It is recommended that the Jordanian government join forces with other governments within the Gulf cooperation council (GCC) countries to develop a regional accounting standard body that will take into consideration the peculiarity of this specific environment. Also, there should be harmonization of legal enforcement systems, competition rules, market access conditions, and effectiveness of the legal systems which have been proven to be factors that appear better able to guarantee comparable accounting practices across countries. The researcher also recommends an empirical study to investigate first-hand the situation from Jordan and also a cross country study that would compare the situations from both developed and developing markets.

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