Report for the AFAANZ grant received for 2017-2018

(1) Name, Position, Contact Details for each applicant

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(2) Project Title

Corporate governance, accruals and real-activities based earnings management: Southeast Asian evidence

(3) Updated Project Summary (500 words) including any variations between the project undertaken and the original application

This project investigates whether the adoption of IFRS has induced firms to engage in real activities based earnings management (REM) to a greater extent, possibly leading to a substitution effect from accrual-based earnings management (AEM) to REM in Southeast Asian countries, namely Philippines, Malaysia, Thailand and Singapore for the period 1996 – 2015. This study also examines the role of corporate governance on earnings management behaviour under the IFRS regime, in particular, whether the corporate governance mechanisms circumvent the trade-off between AEM and REM in the post IFRS era.

Prior research suggests that managers switch from AEM to REM in environments of tighter accounting standards such as IFRS, since REM is relatively more difficult to be detected than AEM. However, real activities are more costly than accruals to manage earnings, since real activities based earnings management distort the fundamentals of the business. Accordingly, substitution of REM for AEM is likely to be an undesirable consequence of IFRS adoption.

Prior evidence on the effect of IFRS on firms' trade-off between AEM and REM is limited and inconclusive. In particular, developing market context has not attracted much attention. In the context of developing markets with weak institutional and regulatory environments, firms in general do not have high quality reporting incentives. Accordingly, such firms may be more inclined to switch from AEM to REM in order to conceal poor performance after adopting IFRS. We find that mandatory IFRS adoption significantly increases REM at the expense of AEM in economies with lax regulation and weak investor protection.

We also examine the joint effect of corporate governance and mandatory IFRS adoption on firms' accounting choices and earnings management behaviour. Strong board governance should have more efficient internal control and monitoring mechanisms that can constrain managers' earnings management activities via real business transactions. We investigate how firms' substitution of REM for AEM changes with specific firm-level corporate governance characteristics. We find significantly less substitution effect from AEM to REM in the post-IFRS era for firms with strong governance characteristics in particular in countries with weak investor protection and regulatory environments. Such results indicate that the monitoring role of corporate governance prevails when firms are faced with weak investor protection and regulatory environments, and that strong governance curtails firms' trade-off between AEM and REM after IFRS adoption.

(4) Funds Granted

$5,000

(5) Detailed Report on Expenditure of Funds against Budget Items, with variations explained

As planned, we spent $5,000 on engaging research assistants to hand-collect corporate governance variables for our sample and control firms for the period 1996 – 2015. The payment was made for approximately 167 hours of data collection work. There was no change or variation made to the original intended usage of the funds specified in the grant application.

(6) Outcomes, for example, working papers, presentations and publications (give full details, including abstracts

We were required to hand-collect data for the period 1996 – 2015 to measure corporate governance attributes for all listed firms in our four sample countries in Southeast Asia: Philippines, Malaysia, Thailand and Singapore, and two non-IFRS adopters in the same region, Indonesia and Vietnam that are used as a control group in the study. As the fund we received was not enough to cover the entire amount of data to be hand-collected, the authors were required to undertake additional hand-collection of data extending the data collection period that we originally anticipated for the project. We have completed the entire hand-collection of corporate governance variables required for all our sample and control firms and this process has resulted in 90,403 observations for the study. As briefly stated in the project summary section (3), we have currently finalised the basic/main empirical work and found the results that mandatory IFRS adoption induced firms to engage in REM to a greater extent, leading to a substitution effect between AEM and REM in Southeast Asia. In particular, the substitution effect was significantly more prevalent in the economies with weak investor protection and regulatory environments. However, firms with strong corporate governance features did not appear to increase REM at the expense of AEM in the post-IFRS era. We are currently working on additional tests to address 1) potential endogeneity issues between the firm performance, managerial reporting incentives and financial reporting quality, 2) to mitigate potential confounding events that may affect sample firms' AEM and REM activities, but are unrelated to mandatory IFRS adoption and 3) to ensure that our results are robust to various model specifications.

(7) Future Intentions for this Project (give full details)

a. Conference submissions

We are currently planning to submit the paper to Journal of Contemporary Accounting and Economics (JCAE) Mid-year symposium 2019.

b. Journal submissions

We are aiming at submitting the paper to Accounting & Finance or Journal of Contemporary Accounting and Economics (JCAE) in 2019.

c. Grant applications

N/A. Data collection is complete, so no further grant is required for this project.

d. Projects

Identification of future research opportunities:

It would be interesting to extend our project to further investigate which particular aspects of managerial characteristics or incentives extenuate or mitigate the substitution effect from AEM to REM. This will enable us to address how changes in accounting regimes interact with corporate governance in shaping a firm's reporting behaviour in particular in the setting in which firms are faced with weak investor protection and institutional and regulatory environments. We are currently planning to develop this research question into our future project.

(8) Summary of Outcomes and Benefits

From our empirical analysis, our findings indicate that the mandatory adoption of IFRS in Southeast Asia has led to a substitution between AEM and REM particularly in the countries with lax regulation and weak investor protection. However, strong governance curtails firms' such trade-off between AEM and REM after IFRS adoption.

It is often cited in the IFRS literature that the impact of IFRS cannot be similar in all countries and financial reporting quality will not improve as a result of it for all firms. In fact, previous similar IFRS studies conducted in different jurisdictions have often produced contradictory results. However, international IFRS studies on earnings quality tend to focus on developed countries (e.g., EU countries). Accordingly, findings on the effect of IFRS mandatory adoption on firms' trade-off between AEM and REM and the role of corporate governance on such earnings management behaviour under the IFRS regime in the setting of Southeast Asian economies provide new insights concerning the joint effects of corporate governance and IFRS adoption on firm's earnings management behaviour in the context of developing markets. In particular, to the best of our knowledge, this study is the first to investigate the role of corporate governance on trade-off between AEM and REM and how their relationship is affected by mandatory IFRS adoption, in particular in the setting in which firms are faced with weak investor protection and institutional and regulatory environments.