

## International Financial Reporting Standards and Financial Information Quality: Principles versus Rules-based Standards

*(Piawaian Pelaporan Kewangan Antarabangsa dan Kualiti Maklumat Kewangan: Perbandingan Antara  
Piawaian Berasaskan Prinsip dan Berasaskan Peraturan)*

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### ABSTRACT

*The objective of the present study is to examine whether the adoption of International Financial Reporting Standards (IFRS) increases financial information quality. The IFRS brings about substantial changes in accounting standards. One of the prominent features of the system is that it results in the production of financial information of higher quality. Most extant studies in this area are performed at firm-level. The present study, on the other hand, examines the impact of IFRS adoption at the country-level. Environmental determinism theory states that accounting is a function of environmental variables, such as ownership structure, information environment and capital market condition. Therefore, the impact of IFRS adoption could be different across different countries. The present study addresses the existing lack of research that compares the outcomes of IFRS adoption between countries. Besides comparing the quality of financial information before and after the adoption of IFRS, the present study also compares the effects of IFRS adoption between countries with different accounting bases prior to the adoption. The results show that financial information quality, measured by five indicators, improves after IFRS adoption; and that the impact is more prevalent in a rules-based country compared to a principles-based country.*

*Keywords: IFRS; information quality; Malaysia; the Philippines*

### ABSTRAK

*Matlamat kajian ini adalah untuk melihat sama ada penggunaan International Financial Reporting standards (IFRS) dapat meningkatkan kualiti maklumat kewangan. Terdapat perubahan ketara terhadap piawaian perakaunan berikutan peralihan kepada IFRS. Antara ciri IFRS yang sering diketengahkan adalah ia memungkinkan penghasilan maklumat kewangan yang lebih tinggi kualitinya. Berbeza dengan kajian lepas yang melihat kesan IFRS pada peringkat firma, kajian ini mengkaji kesan IFRS di peringkat negara. Menurut teori penetapan persekitaran, perakaunan dipengaruhi oleh faktor persekitaran seperti struktur pemilikan, persekitaran maklumat dan keadaan pasaran modal. Berdasarkan teori ini, kesan peralihan kepada IFRS mungkin berbeza antara negara. Kekurangan kajian lepas yang mengkaji di peringkat negara mendorong kajian ini untuk dijalankan. Di samping melihat perbezaan dalam kualiti maklumat kewangan sebelum dan selepas penggunaan IFRS, kajian ini turut meneliti dan membandingkan kesannya antara dua buah negara yang mengguna pakai dua asas piawaian perakaunan yang berbeza sebelum penggunaan IFRS. Hasil kajian menunjukkan kualiti maklumat kewangan meningkat selepas penggunaan IFRS. Keputusan ujian juga menunjukkan bahawa peningkatan kualiti lebih ketara bagi negara yang berubah dari asas berdasarkan peraturan dalam penyediaan piawaian perakaunan ke IFRS.*

*Kata kunci: IFRS; kualiti maklumat; Malaysia; Filipina*

### INTRODUCTION

The demand for high quality financial information has increased in the past few years due to recent financial scandals, such as Enron and WorldCom (USA); Renong (Malaysia); and HIH Insurance (Australia) (Gaio 2010). The lack of transparency and low quality financial information disclosed are among the contributing factors to these scandals (Muniandy & Ali 2012). Such scandals generated calls for increased transparency and prompted authorities and scholars to determine ways to encourage firms to prepare and disclose high quality financial information.

Academicians, such as Armstrong et al. (2010), believe that one promising mechanism is the application of a common set of standards. In order to create a uniform global system for financial reporting, the International Accounting Standards Committee (IASC) was formed in 1973. The principal ambitions of the IASC include developing International Accounting Standards (IASS) with the aim of harmonizing the accounting standards. However, little success has been made in relation to the goal of harmonization. Among the cited reasons for the failure to achieve harmonization is that IASS are not sufficiently comprehensive flexible to be applied to the numerous alternatives available for resolving a singular accounting issue (Saudagaran 2004).

The increasing internationalization of businesses has also prompted new calls from major securities market regulators for more uniform financial reporting across countries. Such calls triggered the IASC to improve existing accounting standards through the restructuring of the IASC to International Accounting Standards Board (IASB). Today, the IASB establishes the International Financial Reporting Standards (IFRS) for private-sector enterprises around the world (Camfferman & Zeff 2006).

Following the IASB decision to change its standards to IFRS, many countries that adopted the IFRS realized that the IFRS differed greatly from domestic accounting standards. As a result, such countries were required to make substantial changes in their domestic accounting standards in order to implement international standards and be consistent with the relevant interpretations of such standards. The main selling point of the IFRS is that it leads to higher quality financial information (Daske & Gebhardt 2006). Extant studies examining developed countries document an increase in financial information quality after IFRS adoption (e.g., Prather-Kinsey et al. 2008), but most of the studies are performed at firm-level. The present study adds to knowledge concerning IFRS adoption by not only comparing the quality of financial information before and after IFRS adoption in developing countries, but also providing a comparison of the impact of IFRS on financial information quality between countries with different accounting backgrounds. Environmental determinism theory (e.g., Cooke & Wallace 1990) states that accounting is a function of environmental variables, such as colonial ties and accounting background.

The present study focuses on the quality of financial information produced at country-level as opposed to firm-level, which is an approach rarely taken by extant studies in this field. Countries in the Asian region are categorized as developing countries. For this reason, the population of the current study consists of the ASEAN-5 countries, which includes Malaysia, Indonesia, Singapore, the Philippines and Thailand. From the ASEAN-5 countries, Malaysia and the Philippines are chosen as the sample for the present study. The two countries are selected on the basis of the approach adopted regarding accounting standards. While Indonesia and Thailand are influenced by rules-based accounting standards, the influence is not as great as in the Philippines (Saudagaran & Diga 2000). Furthermore, while Malaysia and Singapore are influenced by principles-based accounting standards, the Singaporean economy can be considered as more developed than its counterparts in this region. The selection of Malaysia and the Philippines serves as a control mechanism to ensure that the difference in quality of financial information is not due to the differences in the economic structure of the countries examined.

Data on foreign direct investment (FDI) compiled by Sussangkarn et al. (2011) show that Malaysia and the Philippines are ranked second and fifth, respectively, in 1990 in terms FDI and each falls one level in 2007. Although Malaysia and the Philippines are in the same

region; have similar levels of economic development; are common law countries; and have similar cultural and market structures, the two countries have different colonial ties and accounting standards bases. Accounting standards in the Philippines are influenced to a vast degree by US accounting regulations, while Malaysian accounting standards are adapted from UK accounting standards (Saudagaran & Diga 1997, 2000; Saudagaran 2005). The US accounting standards are more rules-based, while UK accounting standards are principles-based. For these reasons, the present study only includes Malaysia and the Philippines in the sample in order to ascertain the differences between the two countries following IFRS adoption, particularly in regards to the quality of financial information produced.

Extant studies examine the differences between rules-based of accounting standards and principles-based accounting standards (Okamoto 2010). Findings from such studies not only highlight the differences between the two bases, but also address the theoretical contingency that the impact of IFRS adoption on principles-based countries may be less prevalent than rules-based countries due to the fact that the IFRS is a principles-based accounting standard (Agoglia, Douppnik & Tsakumis 2011). Such differences provide an opportunity to study not only whether IFRS adoption improves financial information quality, but also whether the changes are more prevalent when a country switches from rules-based accounting standards to IFRS. Therefore, the present study adds to existing knowledge regarding the role of accounting standards in improving financial information quality in an environment where financial information is not rich (Gibson 2003).

International accounting literature indicates that accounting and financial reporting in a country is a function of its environment (e.g., Belkaoui 1983; Cooke & Wallace 1990), which includes aspects such as ownership structure. Most firms in Asia are family owned with highly concentrated ownership structures (Claessens & Fan 2002; Claessens, Djankov & Lang 2000), which may contribute to asymmetric information problems. Investors depend heavily upon financial information disclosed by firms when making investment decisions. High information asymmetry problems and low financial information quality may discourage investors from participating in the capital market due to higher uncertainty and risk regarding investments. Investment is vital for developing countries as it can contribute to the development of the economy. Local and foreign investments promote productivity, employment and exports, which contribute to economic growth and development. Investors are more enthusiastic to invest or buy shares in firms that disclose higher quality financial information (Tan et al. 2007).

Financial reporting quality is considered high when disclosed financial information reflects the underlying operating performance and financial position accurately. Conceptually, the provision of high quality financial information in accordance to a set of high quality accounting standards that are transparent and comparable will attract

investors and analysts because they can understand and compare the financial information of several firms (Tan et al. 2007). The importance of financial information is stressed by Rankin et al. (2012: 227) in the statement that “Information is the oil that lubricates markets.” This implies that for a market to work efficiently, the financial information that is being disseminated must be reliable, relevant and of high quality. Reliable and accessible financial information will lower transaction costs, which in turn bolsters resource allocation and economic growth. The quality of financial information produced by firms is influenced, to a certain extent, by the accounting standards of a given country. Accounting standards can be seen as an instrument that regulates the quality and quantity of corporate financial information. In other words, the quality of financial information can be institutionalized through accounting standards. The standards, however, need to be updated and upgraded to cater for changes in the business environment and practices.

Previous studies examine the outcomes of IFRS implementation, but primarily at the firm level (e.g., Daske et al. 2008). To examine whether the quality of financial information can be institutionalized, a comparison needs to be performed at the regional or country-level instead of the firm-level. The methods used for firm-level studies are not suitable for cross-country analysis (Tang et al. 2012). Firm-level differences in financial reporting quality are associated with management incentive, while national differences reflect the characteristics of the legal systems, capital market development and investor protection (Leuz et al. 2003); culture (Guan & Pourjalali 2010); corporate governance practices (La Porta et al. 2000); and accounting standards. This motivates the investigation of the effect of IFRS adoption at the country-level using accounting and auditing data in the present study.

The Philippines adopted the IFRS in 2005, while Malaysia adopted the IFRS in 2006. The adoption of the IFRS by the two countries provides another opportunity to investigate whether the new set of standards improve the quality of financial information as claimed by the standard setters. The present study provides early evidence concerning the impact of IFRS adoption on financial information quality at the country-level. The selection of two countries with two different accounting standards bases prior to IFRS adoption further adds to knowledge regarding the impact of IFRS adoption. Findings from the present study should be of interest to policy makers in other countries when contemplating whether and when to adopt the IFRS. The findings will also help individual, institutional and foreign investors to better understand the reporting environment in Malaysia and the Philippines. The results of the present study could also be of interest to academicians involved in guiding and researching progress towards the harmonization of accounting standards. In addition, the findings are beneficial to regulators and authorities involved in financial and accounting services because decision makers could be misled into making

sub-optimal decisions without appropriate knowledge of the impact of these changes.

The remainder of the paper is organized as follows. Section 2 discusses extant studies and the development of the hypotheses of the present study. Section 3 describes the methodology employed in the present study, including the description of the sample and variables involved. Section 4 discusses the results and robustness test, followed by a conclusion in section 5.

## LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### INTERNATIONAL FINANCIAL REPORTING STANDARDS

The IFRS is substantially different compared to previous standards, due to the fact that the IFRS is more capital market oriented; more relevant to investors; and more comprehensive, particularly in regards to disclosure (Daske & Gebhardt 2006). As a proponent of IFRS, Rankin et al. (2012) insist that without a single set of global accounting standards, cross-border investment may be distorted; monitoring of investment may be obscured; and contracting inhibited. Armstrong et al. (2010) believe that the application of a common set of standards will have convergence benefits, such as lowering the costs of comparing the financial positions and performances of firms across countries. Armstrong et al. (2010) are of the opinion that IFRS adoption will also enable the capital markets of adopting countries to become more globally competitive. According to Ball (2006:11), “IFRS promise more accurate, comprehensive and timely financial statement information. To the extent that financial statement information is not known from other sources, this should lead to more-informed valuation in the equity market, and hence lower risk to investors.” Similarly, Chow et al. (2010) posit that the adoption of IFRS is projected to lead to more disclosure and less opportunity for income smoothing. In short, the elimination of some choices of accounting method, the use of fair value accounting and a higher level of disclosure will provide more relevant and comparable financial information, two important characteristics in regards to financial information quality. Despite the potential benefits, IFRS adoption is not without costs and limitations.

One of the debatable issues against the IFRS is its new measurement of fair value. In order to calculate the value, asset pricing markets must exist. However, it is likely that in some countries, particularly the non-developed countries, the asset pricing markets are not sufficiently deep to provide the necessary data with which to revalue many of the assets reliably. This means that firms in such countries will have to turn to synthetic approaches, such as using fair value models or estimation based on similar assets. As a result, estimated values are not truly comparable among all countries (Hoogendoorn 2006).

Rankin et al. (2012) argue that convergence may be beneficial for large multinational entities and institutional investors, but it is unlikely to benefit entities which operate only in one jurisdiction and do not seek international sources of funds through global markets. For such entities, the increased compliance costs will likely outweigh the benefits of convergence.

In addition, extensive training and education will be required to ensure that financial statements are correctly prepared, interpreted and audited (Haller & Eierle 2004). Howieson (1998) believes that investors may need to acquire the necessary skills to evaluate financial statements prepared under international accounting standards. This could initially cause uncertainty and confusion for investors, which may also lead to less enthusiasm to invest in foreign firms. In addition, Walters (2003) posits that as budgets and performance evaluation measures are based on financial accounting information, firms must consider the potential impacts of IFRS adoption on their management accounting systems. In short, the cost of changing to new sets of accounting standards may be substantial and the cost of the required changes can be higher the greater the number of changes.

#### PRINCIPLES-BASED VERSUS RULES-BASED STANDARDS

There are two approaches to standards setting, namely principles-based and rules-based (Nobes 2005). Under a principles-based approach, accounting standards contain few (if any) rules. Such accounting standards consist of broad principles and rely on the users of the standards to make professional judgment in respect of the accounting issues at hand. In contrast, a rules-based approach requires the users of accounting standards to follow detailed and specific rules in determining the appropriate accounting treatment for a transaction or event. Significant debate exists in accounting literature concerning the relative merits of principles-based accounting standards and rules-based accounting standards that suggests the two approaches are mutually exclusive (e.g., Nobes 2005; Rankin et al. 2012; Schipper 2003).

Academicians, such as Thomadakis (2007), prescribe the use of principles to guide the actions of individuals and groups rather than establishing detailed sets of rules. Thomadakis (2007) views principles as having an inherent aspirational quality that rules simply cannot support. Another highly practical attraction is that establishing principles rather than rules allows regulation to respond effectively to evolving conditions without the need for constant amendment. Rankin et al. (2012) suggest that the tendency to manage earnings is reduced under principles-based standards because the use of principles makes the structuring more difficult to justify. Principles-based standards also allow accountants to use their professional judgment in assessing the substance of a transaction, a service that highlights their professionalism to the clients.

Opponents of principles-based standards, on the other hand, argue that the imprecision of principles-based standards might lead to abuse by account preparers or give rise to confrontation between account preparers and auditors (Henry 1999). Opponents also claim that principles-based standards typically require preparers and auditors to exercise judgment without providing sufficient structure to frame that judgment, which results in a significant loss of comparability among reporting entities. Rules-based standards, on the contrary, are argued to result in the production of financial information that is highly comparable.

The proponents of the rules-based approach insist that detailed rules and authoritative guidance provided by rules-based standards lead to fewer opportunities for managers to use judgment in order to manage earnings and manipulate accounting numbers (and also for auditors to be forced to accept such practices). Rankin et al. (2012) are of the opinion that rules-based accounting standards reduce exposure to litigation for an entity and its auditors when the rules are applied properly. Nobes (2005) also posits that rules-based standards reduce imperfections that lead to misreporting, which makes a firm erroneously appear more attractive to investors.

The most significant weakness of the rules-based approach relates to the attempt to cover all contingencies (Rankin et al. 2012). The diversity of entities and the many unique situations covered by the reporting system gives rise to particular problems, such as the excessive complexity of procedures, which can lead to confusion and even manipulation. Auditing can also be more difficult because managers can justify their manipulations as compliance. Compliance with the letter of the law may nonetheless be contrary to the spirit of the law (Nobes 2005). Other critics of rules-based standards have pointed out that rules can become useless and, worse yet, dysfunctional when the economic environment changes or as managers create innovative transactions to circumvent the standards (Kershaw 2005). Due to these weaknesses, after extensive research, the US Security and Exchange Commission (SEC) reached the conclusion that accounting standards setting should not be based on detailed rules but on simpler principles.

In short, both standards setting bases (i.e., principles-based and rules-based) have their own merits. Principles-based standards supply broad guidelines that can be applied to many situations. Broad guidelines could improve the representational faithfulness of financial statements. For example, managers are less likely to attempt earnings management under principles-based approach, while auditors are also less likely to permit earnings management. However, the inherent latitude of principles-based standards provides a situation that managers are able to select treatments that favor their personal interests or those of the shareholders. Under this condition, even when unbiased statements are produced, the judgment and choices involved in many of the decisions mean that comparability among financial

statements may be reduced. On the other hand, rules-based standards improve financial information quality by increasing comparability between financial statements. However, under rules-based approach, regulations must be constantly amended to respond effectively to evolving conditions. Just as consistency of actions promotes confidence, frequent amendments to rules can actually undermine consistency. Lack of consistency leads to lower financial information quality. Given the strengths and weaknesses of these two different standard setting bases and their effects on financial information quality, it is pertinent to study whether the IFRS improves financial information quality of adopting countries, especially when the standards used prior to IFRS are of different bases.

Furthermore, considering that the IFRS is a principles-based standard, it can be argued that the cost of changing to IFRS will be lower for countries that already employ principles-based standards compared to countries that initially followed rules-based standards prior to IFRS implementation. Therefore, to justify the change to the IFRS, countries employing rules-based standards need to be certain that the benefits gained by adopting the IFRS outweigh the costs.

#### ACCOUNTING STANDARDS AND FINANCIAL INFORMATION QUALITY

Accounting standards are country specific to cater for the differences in business environment, legal structure and enforcement agencies. The introduction of the IFRS is a step towards the harmonization of accounting standards that seeks to provide comparability of financial reporting. Empirical studies demonstrate the benefits of the IFRS, especially in terms of improving financial information quality (e.g., Brochet, Jagolinzer & Riedl 2013; Iatridis 2010). Such studies, however, are performed at the firm-level and in developed countries. The impacts of IFRS adoption in different environments, such as developing countries, have yet to be extensively studied and the analysis at country-level has yet to be examined. By analyzing the impact at the country-level, the present study attempts to investigate whether financial reporting quality can be institutionalized through accounting standards. Institutional theory proposes that organizations adopt prescribed programs and procedures by states and/or professional bodies to increase the probability of their survival (Zucker 1987). From this perspective, it can be suggested that the prescription of appropriate programs and procedures, such as the IFRS, can reduce the amount of reporting discretion relative to many local sets of generally accepted accounting principles (GAAP) and consequently compel companies to improve their financial reporting quality.

The implementation of the IFRS is considered beneficial to adopting countries due to the standards having an excellent reputation; and being of good quality and high credibility (Ball 2006). Arguments in favor of the IFRS include the fact that the adoption of the IFRS

improves financial reporting to outside investors; the IFRS is more capital market oriented; and the IFRS is more comprehensive, especially with regard to disclosure, than most local GAAPs (Daske & Gebhardt 2006). The IFRS is also argued to reduce the amount of reporting discretion relative to many local GAAPs and, subsequently, compel firms to improve their financial reporting quality. Consistent with this argument, Ewert and Wagenhofer (2005) show that reducing the variability of accounting standards and available methods can reduce the level of earnings management and improve reporting quality. From another point of view, using the same set of accounting standards can improve investors' ability to detect earnings management and accounting manipulations because the accounting standards limits the set of permissible accounting treatments, which should also improve reporting quality (Ball 2006).

An important feature of IFRS is the use of fair value accounting. The progress towards fair value accounting from historical cost accounting is expected to result in financial statements that are more relevant, timely and credible (Wan Ismail et al. 2010), which may lead to higher financial information quality. A primary advantage of fair value accounting is that it provides accurate asset and liability valuation on an ongoing basis to users of the reported financial information of a firm, which provides better insight to the users for decision making.

Extant empirical studies find a higher quality of financial information after IFRS adoption. Prather-Kinsey et al. (2008), for example, find that capital market participants in 16 European countries consider the financial reports to be more value relevant and informative, resulting in a lower cost of capital after IFRS adoption. Prather-Kinsey et al. (2008) also find that firms from code law<sup>1</sup> countries experience more significant market consequences from IFRS implementation than firms from common law countries. Prather-Kinsey et al. (2008) suggest that one of the important variables to be included in study on the impact of IFRS is the legal structure of the country.

Similarly, Belkaoui (1983) and Muniandy and Ali (2012) find that the nature of the legal system is one of the factors that affect the financial reporting systems of different countries. Daske et al. (2008) examine the impact of IFRS adoption in 26 countries on market liquidity, cost of capital and equity valuations; and find an increase in market liquidity and equity valuations, as well as a decrease in cost of capital around the adoption of IFRS. Daske et al. (2008) find that these capital market effects are stronger in countries that have larger differences between the local GAAP and the IFRS. Prather-Kinsey et al. (2008) and Daske et al. (2008) are cross-countries studies that investigate the impact of IFRS adoption on capital markets. Although these studies are cross-country studies, comparisons are made at the firm-level. However, the legal system of a given country may influence the financial reporting practices in the country (Muniandy & Ali 2012). A comparison of the impact at country-level

is therefore deemed necessary and, hence, one of the objectives of the present study. The present study not only investigates the impact of IFRS adoption on financial information quality, but also compares the impact of IFRS adoption on countries with different accounting standards structures prior to IFRS adoption.

Countries in Asia are still influenced by links with their previous colonial powers (Saudagaran 2005), such as the US in the case of the Philippines and the UK in the case of Malaysia. Both the US and the UK are distinguished members of common law countries. However, US standard setters follow the rules-based approach when establishing accounting standards, while UK standard setters apply a principles-based approach. Due to the differences in structural background (i.e., both are common law countries, but apply different accounting standards approaches prior to IFRS adoption), Malaysia and the Philippines are chosen as the sample of the present study to investigate the effects of IFRS on the quality of financial information.

Based upon institutional theory and the findings of extant studies (Ball 2006; Daske & Gebhardt 2006), the argument can be made that the adoption of IFRS could lead to an increase in the quality of financial information. Previous empirical studies investigate the effect of IFRS adoption on financial information quality within advanced countries (e.g., Barth et al. 2008; Daske et al. 2008; Prather-Kinsey et al. 2008). However, to the best of our knowledge, no extant published research directly examines the impact of IFRS adoption on financial information quality in developing countries. The environments of developed and developing countries differ in terms of market efficiency; enforcement systems; firm ownership; and organizational structures. Peng et al. (2008) point out that standards developed by the IASB are primarily aimed at countries with highly developed capital markets. As a result, it is questionable whether such standards are optimal for developing and transitional economies that lack the infrastructure to monitor financial reporting decisions. Thus, an empirical research that can provide substantiated evidence on the outcome of IFRS appears urgently needed. In line with prior findings, the present study hypothesizes that financial information quality increases after IFRS adoption in both rules-based and principles-based countries. The first hypothesis is therefore stated as follows:

H<sub>1</sub> Financial reporting quality is higher after IFRS adoption.

In favor of principles-based standards, Webster and Thornton (2005) provide preliminary evidence that Canadian listed firms applying Canada's relatively principles-based GAAP have higher accrual quality and indicate higher financial information quality than firms applying the relatively rules-based GAAP of the US. At the firm level, Agoglia et al. (2011) show that American chief finance officers exhibit more agreement and are less likely to report aggressively under principles-based accounting.

Deng (2007) proposes a model and demonstrates that entrepreneurs may have less incentive to manipulate accounting numbers under a principles-based accounting system. On the other hand, Deng (2007) believes that rules-based standards grant more discretion to entrepreneurs in structuring and justifying transactions. Subsequently, the informativeness of the financial accounting information is reduced because entrepreneurs are just following details to achieve desired financial numbers. The aforementioned studies suggest that financial information quality is higher under principles-based accounting standards than rules-based accounting standards.

Accounting standards in the US are rules-based (Schipper 2003), where rules are set for every potential situation. Firms in such an environment are able to structure transactions to circumvent unfavorable reporting. This was cited as one of the reasons for the financial reporting scandals of Enron Corporation and WorldCom in the US (Gaio 2010). Consequently, this leads to the SEC favoring principles-based standards. As a result, authorities in Financial Accounting Standards Board (FASB) and IASB, under a joint-effort propose plans to align the US GAAP with the IFRS, which is a principles-based accounting standard. The joint-effort of the FASB and the IASB in bringing US GAAP closer to the IFRS is an indication that principles-based standards are seen as superior to rules-based standards, at least in terms of the quality of financial information. Therefore, the positive impact of IFRS adoption in countries that have previously used a rules-based approach to accounting standard setting may be more prevalent than countries that have consistently used a principles-based approach for local accounting standards. Such a presumption is consistent, to a certain extent, with Daske et al. (2008), who demonstrate the positive impact of IFRS adoption on financial information quality is stronger in countries that have larger differences between the local GAAP and the IFRS. However, Daske et al. do not address the impact at the country-level and whether or not the impact is different among countries with different accounting backgrounds.

The IFRS adoption by both Malaysia and the Philippines provides an opportunity to investigate the differences between rules-based and principles-based standards in terms of the role of standards in ensuring the quality of financial information produced and reported by listed firms. The Philippines is switching from a local GAAP, which is very much influenced by the US GAAP, to IFRS. Malaysia, on the other hand, has been influenced by the principles-based standards of the UK since colonization. Due to the differences in accounting standard backgrounds, the impact of IFRS adoption, in terms of financial information quality, should be greater in the Philippines than in Malaysia. Thus, the second hypothesis of the present study is as follows:

H<sub>2</sub> The improvement in financial reporting quality in rules-based countries is more prevalent compared to principles-based countries after the adoption of IFRS.

## METHODOLOGY

## SAMPLE

Two clearly discernible groups of accounting regulations exist among the ASEAN-5 countries. The first group, consisting of Indonesia, the Philippines and Thailand, are influenced to varying degrees by US accounting regulations, albeit the Philippines more strongly so compared to Indonesia and Thailand (Saudagaran & Diga 2000). The second group, consisting of Malaysia and Singapore, generally adopted the accounting practices of the UK (Saudagaran & Diga 2000; Saudagaran 2005). The principles-based approach to accounting standards has been the preference of UK standard setting bodies for many years (Psaros 2007). An overview of the standard setting process in the US identifies factors fostering the rules-based accounting system (Alexander & Jermakowicz 2006; Schipper 2003). Therefore, Malaysia and the Philippines are chosen for the present study because while Malaysia's accounting standards follow principles-based accounting standards, the accounting standards of the Philippines are rules-based. Malaysia, rather than Singapore, is chosen because it is closer to the Philippines in terms of FDI ranking. The Philippines is chosen because the influence of rules-based standards is more dominant compared to Thailand and Indonesia. The distinction in approach to accounting standards between the two countries, coupled with the similarities in FDI ranking, provides an opportunity to not only study whether IFRS adoption improves financial information quality, but also to compare the impact of IFRS adoption on financial information quality in rules and principles-based countries.

At the end of 2004, the Malaysian Accounting Standard Board (MASB) embarked on an effort to align Malaysia's reporting standards with the IFRS. The convergence exercise started in January 2006. As a result, the period examined prior to IFRS adoption for Malaysia is 2004, while the period examined after the IFRS adoption is

in 2007. The year 2004, 2 years before IFRS adoption, is chosen because sizable missing data was found for 2005 and the final sample was not appropriate for testing.

As an associate member of the International Accounting Standard Committee (IASC), the Accounting Standards Council (ASC) of the Philippines issued accounting standards with their IAS counterparts which became effective from 1 January 2005. Therefore, the period examined prior to IFRS adoption in the Philippines is 2002, while the period examined after IFRS adoption is 2006. Sizeable missing data exists for the years of 2003 and 2004, which results in the use of data from 2002 to represent the period before IFRS adoption. The year of implementation is not chosen in either countries because a contingency exists that firms may not have been able to comply with all of the new accounting standards.

The required data of the study is obtained from Osiris and DataStream databases. The population of this study consists of all firms listed under the Main Market of Bursa Malaysia and the First Board of the Philippines Stock Exchange. Firms in financial services are subject to different regulations and are therefore excluded from the sample list. The sample consists of 862 and 250 firms for Malaysia and the Philippines, respectively, after excluding firms in the financial sector. To Data on depreciation, amortization expense, net income, tax payable, and audit opinion are required in order to measure financial information quality. Firms without the required data therefore must be excluded. A total of 437 of listed firms in Malaysia and 40 from the Philippines are excluded from the sample list due to incomplete data.

The present study attempts to investigate the quality of financial information before and after IFRS adoption. Therefore, the firms included in the sample need to exist before and after IFRS adoption. Due to this requirement, a further 108 Malaysian and 10 firms in the Philippines are excluded. The final sample consists of 317 firms in Malaysia and 200 firms in the Philippines. Table 1 provides basic financial information concerning the firms included in the final sample.

TABLE 1. Profiles of firms in final sample

	Min.	Malaysia Max.	Mean	Min.	Philippines Max.	Mean
Total Assets (US\$m)	1.109	13,374.051	321.373	0.003	17,296.906	628.819
Sales (US\$m)	0.500	5,396.310	162.127	0.001	5,844.545	227.676
Market Capitalization, (US\$m)	0.699	11,651.555	288.628	0.216	50,185.933	686.753
Return on Assets (ROA, %)	-50.25	69.31	4.30	-88.29	69.17	3.55
Number of Employees	4	20,298	1,210	2	37,700	2,104
Number of firms in final sample		317			200	

Total assets, sales and market capitalization are quoted in millions of US Dollars. The minimum and maximum values of total assets and market capitalization indicate that small firms in the Philippines are much smaller than Malaysian firms, but the larger ones are much larger.

The mean values show that, on average, the Philippines firms are larger in size, in terms of total assets and market capitalization. However, sales values are similar between the two countries. This can be due to the values of ROA, where Malaysian firms show higher returns compared to

firms in the Philippines. The profiles demonstrate diversity in regards size and profitability in the sample, but the distribution is normal as shown in Appendix 1.

#### FINANCIAL INFORMATION QUALITY INDICATORS

Several methods of measuring financial information quality exist. Tang et al. (2012) measure financial information quality by introducing some elements of accounting and auditing information that can be associated with financial reporting quality, such as the loss avoidance ratio, accruals magnitude, and the non-Big 4 auditor ratio. Daske et al. (2008), on the other hand, use implicit measurements to measure financial information quality, such as cost of capital and Tobin's q. The lower (higher) cost of capital (Tobin's q) shows higher financial information quality. Prather-Kinsey et al. (2008) evaluate the financial information content of earnings announcements in their value relevance study where the effect of financial information quality on investors' decisions is gauged through the cost of capital.

Most extant research on IFRS adoption, such as Daske et al. (2008) and Prather-Kinsey et al. (2008), are performed at the firm-level. However, the external validity of firm-level research in gauging the market-level impact is debatable. Studies by Chen et al. (2011) and Tang et al. (2012) utilize measurements of financial information quality that is more appropriate for country-level comparisons. The quality of financial information is measured using 5 indicators. The first three indicators (i.e., loss avoidance ratio (LAR), profit decline avoidance ratio (PDAR) and accrual ratio (AR)) are used in order to measure financial information quality from the perspective of earnings management. Extant studies provide evidence that managers have incentives to manipulate profit in order to present a better picture of the firm to the users of financial information, especially investors (Healy & Wahlen 1999). Such earnings management behavior obscures the association between reported earnings and true actual performance, and accordingly, reduces quality of financial reporting.

Financial information quality is also measured from an auditing perspective because auditing directly or indirectly affects financial reporting practices. Auditors can affect financial reporting system in several ways. For instance, an auditor can help an entity to choose appropriate accounting methods and standards to account for complex transactions. An auditor also plays a role in evaluating internal control procedures and advises management on ways to improve financial reporting quality. The indicators for assessing the financial information quality from an auditing perspective are the Qualified Audit Opinion Ratio (QAOR) and Non-Big 4 Auditor Ratio (NBAR).

Extant studies (e.g., Francis & Michas 2013) suggest that the independent auditing of financial statements is one of the foundational elements of financial information quality and effective operation of the capital markets. The argument is premised upon the finding that an audit can effectively reduce and mitigate information asymmetry;

and constrain aggressive and potentially opportunistic reporting. Similarly, Francis et al. (1999) state that auditing is an independent verification that enhances financial statement reliability and usefulness. Therefore, the cumulative outcomes of investigating financial information quality from financial and auditing aspects can improve the robustness of the findings. The chosen measurements are also easier to understand compared to other measurements that are used in extant studies.

*Loss Avoidance Ratio (LAR)* The shareholders of firms often use a simple and explicit earnings-based benchmark to evaluate the financial positions and performances of firms. This may cause managers to manipulate earnings with the intention of presenting a more promising picture of a firm. The incentive for such manipulation is higher when managers' compensations are based upon these sorts of measurements (Healy & Wahlen 1999). The motivations for self-wealth maximization of managers can result in a higher than expected number of firms with small profits. Extant studies generally support such findings. For instance, Burgstahler and Dichev (1997) provide evidence that firms in the US actively engage in earnings management to avoid reporting losses.

In their seminal paper, Burgstahler and Dichev (1997) find that earnings management to avoid annual losses is common and estimate that from 30 to 44 percent of firms with small pre-managed (before earnings management) losses take actions to raise reported net income from a small loss to positive income. Burgstahler and Dichev (1997) also report evidence of earnings management to avoid losses for quarterly earnings and find that earnings management increases when pre-managed earnings of firms are around zero because this provides greater marginal benefit to management. Furthermore, Burgstahler and Dichev (1997) document that almost no management in earnings at other levels of earnings exist. Jacob and Jorgensen (2007) confirm these findings. Such earnings management behavior obscures the relationship between accounting earnings and underlying economic performance, thus reducing financial reporting quality.

The LAR is a fraction (Burgstahler & Dichev 1997; Leuz et al. 2003; Tang et al. 2012) that utilizes the total number of firms with small profits as the numerator and the total number of firms with small losses as the denominator. Firms with small profits are defined as firms with a net income scaled by lagged total assets between 0 and 1, while firms with small losses are defined as firms with net income scaled by lagged total assets between 0 and -1. The higher the ratio, the greater the level of earnings management, and, thus, the lower the quality of financial reporting quality.

*Profit Decline Avoidance Ratio (PDAR)* The second indicator is PDAR. Burgstahler and Dichev (1997) find that managers manipulate their earnings in order to avoid earnings decreases. Additionally, Burgstahler and Dichev (1997) find that between 8 and 12 percent of firms with small pre-managed earnings decrease manage earnings to

create a positive change in reported income and earnings management increases when the pre-managed earnings of firms are around zero because this provides greater marginal benefit to management.

Similarly, DeAngelo et al. (1996) find that a break in a pattern of consistent earnings growth is associated with a large decline in stock price. Barth et al. (1999a) and Barth et al. (1999b) show that firms with longer strings of consecutive profit increases are priced at a premium and that when such firms experience declines in profit, the premiums fall considerably. Beatty et al. (2002) demonstrate that public banks have more incentives to report a steady increase in earnings and tend to report less small profit declines compared to private banks. In short, the price penalties for falling short of prior profit, together with the possible effect of the stock price on managers' compensation packages, provides managers of publicly traded firms with considerable incentives to report a pattern of increasing profit.

The PDAR is a fraction (Burgstahler & Dichev 1997; Chen et al. 2011; Tang et al. 2012) represented by the total number of firms with small profit increases over the total number of firms with small profit decreases. Firms with small profit increases are defined as firms with a change in return on assets ( $\Delta ROA$ ) between 0 and 0.005, while firms with small profit decreases are defined as firms with a change in return on assets ( $\Delta ROA$ ) between -0.005 and 0. A higher ratio indicates a higher level of earnings management and lower quality financial reporting.

**Accrual Ratio** The third indicator is AR, which is a measure of accruals quality. Extant studies use accruals to measure earnings aggressiveness (e.g., Bhattacharya et al. 2003). Accruals magnitude reflects the degree of aggressiveness or conservativeness of an accounting policy. An aggressive accounting policy tends to delay the recognition of losses and accelerate the recognition of gains, while a conservative accounting policy does the opposite. Ball et al. (2000) argue that accounting conservatism implies a more timely incorporation of economic losses into accounting earnings than economic gains, which reduces information asymmetry between managers and investors.

The level of accruals is used to measure the degree of aggressiveness of an accounting system. If cash flows from operations realization are held as constant, accruals are expected to increase as earnings aggressiveness increases. Following extant studies, the present study measures accruals quality using accruals divided by lagged total assets. The following equation is used to calculate AR (Chen et al. 2011; Sloan 1996; Tang et al. 2012):

$$AR = \frac{[(\Delta TCA_{jt} - \Delta Cash_{jt}) - (\Delta TCL_{jt} - \Delta STD_{jt} - \Delta TP_{jt}) - D\&AE_{jt}]}{TA_{jt-1}}$$

Where,

$\Delta TCA_{jt}$  = Change in Total Current Assets  
 $\Delta TCL_{jt}$  = Change in Total Current Liabilities<sub>*j,t*</sub>

$\Delta STD_{jt}$  = Change in Short-Term Debt<sub>*j,t*</sub>  
 $\Delta TP_{jt}$  = Change in Tax Payable<sub>*j,t*</sub>  
 $D\&AE_{jt}$  = Depreciation and Amortization Expense<sub>*j,t*</sub>,  
 and  
 $TA_{jt-1}$  = Lagged Total Assets<sub>*j,t*</sub>

In order to calculate the AR of a country, the AR of all firms (firm-level) in the country must be calculated first. Then, the median of the calculated ARs is determined to represent the AR of the country. Median, rather than mean, is used to minimize the influence of extreme values (Leuz et al. 2003; Tang et al. 2012) because the existence of extreme values in the sample utilized in the present study is significant. A smaller accruals ratio suggests less managerial discretion and less earnings management; and, therefore, higher financial reporting quality for a country or period.

**Qualified Audit Opinion Ratio (QAOR)** Financial statements are the representations of management and used by stakeholders, such as investors, when making decisions. The stakeholders rely on the auditor to verify the credibility of financial statements (Chen et al. 2000; Firth 1978). An audit is an integral part of the modern financial reporting system and can effectively mitigate information asymmetry problems.

When evaluating an accounting system at the country-level, the auditor's opinion and assurance on financial reports should be adequately considered. An auditor, based upon the investigation, may issue an unqualified audit opinion indicating that the financial statements are prepared truthfully and fairly. If the auditor has reservations about the amounts or disclosures, a qualified opinion is issued, which means the financial statements are not true and fair; or contain some other problems. A qualified audit opinion is evidence of low quality financial reporting, holding audit quality constant. Therefore, the fourth financial information quality indicator is QAOR, which is the ratio of the total number of qualified audit opinions to the total number of firms audited. A lower ratio indicates higher quality financial reporting quality for a country or period.

**Non-Big 4 Auditor Ratio (NBAR)** When the proportion of qualified audit opinions between two countries are compared, the size of the firms that employ the auditors who issued the report must also be considered. A low quality auditor may issue an unqualified opinion without rigorous substantive testing. Following extant research, the present study adopts auditor size as a proxy of audit quality. Although large auditing firms are not immune from audit risk and audit failure, large auditors are generally perceived as being more independent (DeAngelo 1981a, 1981b); more experienced; having higher industry expertise (Carcello & Nagy 2003; Krishnan 2003); and making larger investments in professional education and training. Big 4 auditors are more prudent in order to protect their brand name since they have more to lose than non-Big 4 auditors in the event of reputation loss (Krishnan 2005).

The fifth indicator, NBAR, is introduced as a measure of external audit quality. Auditing standards and practices, auditor training and education and the degree of auditor independence varies across countries, as does auditor quality. It is expected that a high level of auditor quality is associated with a higher quality of financial reporting. Therefore, auditor quality is an important element of financial reporting quality. NBAR is calculated as follows:

$$NBAR = 1 - \frac{\text{Total number of Big 4 auditors}}{\text{Total number of the companies audited}}$$

A lower NBAR indicates higher quality financial information.

## RESULTS AND DISCUSSIONS

### DESCRIPTIVE ANALYSES AND RESULTS

The present study investigates the impact of IFRS adoption on financial information quality from two angles. First, the present study investigates whether an increase in the quality of financial information occurs following IFRS adoption. Second, the present study investigates whether the impact of IFRS adoption on the quality of financial information is different between adopting countries with different accounting bases prior to IFRS adoption. In other words, the quality of financial information during the periods before and after IFRS adoption are compared, as well as between the two countries with different accounting bases before the adoption of IFRS. Table 2 shows descriptive statistics of the five indicators before and after IFRS adoption.

TABLE 2. Descriptive statistics

	Pre-IFRS					Post-IFRS				
	LAR	PDAR	AR	QAOR	NBAR	LAR	PDAR	AR	QAOR	NBAR
Mean	3.7	1	-0.014	0.030	0.72	3.45	0.5	-0.024	0.055	0.72
Median	3.7	1	-0.014	0.030	0.72	3.45	0.5	-0.024	0.055	0.72
Maximum	4.1	2	0	0.05	1	3.7	1	-0.02	0.075	1
Minimum	3.3	0	-0.028	0.009	0.44	3.2	0	-0.027	0.034	0.44
Std. Dev.	0.4	1	0.014	0.020	0.28	0.25	0.5	0.004	0.0205	0.28

Notes: LAR = Loss Avoidance Ratio; PDAR = Profit Decline Avoidance Ratio; AR = Accruals Ratio for firm *j* year *t*; QAOR = Qualified Audit Opinion Ratio; NBAR = Non Big 4 Auditors Ratio

As depicted in the Table 2, the means and medians of all 5 indicators before and after IFRS are close indicating data normality (e.g., Gibbons 1964; Li & Wu 2006). The descriptive statistics for the indicators shown in Table 2 are not at firm-level. These indicators are calculated using number of firms with required data in a particular country. For example, the loss avoidance ratio (LAR) is calculated by dividing the number of firms with small profits to number of firms with small losses. Same procedure applies to other indicators. For more explanation on these indicators, interested readers are suggested to refer to article by Burgstahler and Dichev (1997), Leuz et al. (2003) and Tang et al. (2012). Since the indicators are ratios, performing statistical tests, such as t-test, is impossible.

The means for earnings management (consisting of LAR, PDAR and AR) are smaller after IFRS adoption than before IFRS adoption. The means of LAR, PDAR and AR are 3.7, 1 and -0.014, respectively before IFRS adoption, while the means are 3.45 for LAR, 0.5 for PDAR and -0.024 for AR after IFRS adoption. Smaller means after IFRS adoption indicate lower earnings management and higher quality financial information.

On the other hand, the means of indicators that measure financial information quality from the auditing perspective show different results. The means of QAOR are

0.03 before IFRS adoption and 0.05 after IFRS adoption. No changes occur in the means of NBAR, which remain at 0.22. This shows that from an auditing perspective, no changes in financial information quality occur after IFRS adoption.

Each indicator of financial information quality is further calculated on a country basis. An Excel spreadsheet is used to calculate each indicator and the results are shown in Table 3.

The "Change" column in Table 3 shows the differences between the ratios before IFRS adoption and after IFRS adoption for each indicator. This column shows changes, positive or (negative), of indicators measuring financial information quality after IFRS adoption. The first three indicators (LAR, PDAR and AR) measure financial information quality from the perspective of earnings management. The lower (smaller) ratios after IFRS adoption compared to before IFRS adoption indicates lower earnings management and higher financial information quality, and vice versa.

The results in Table 3 show that the LAR of the Philippines reduces from 4.1 before IFRS adoption to 3.2 after IFRS adoption, which indicates that earnings management decreases and financial information quality is higher after IFRS adoption. The same indicator for Malaysia increases from 3.3 before IFRS adoption to

TABLE 3. Results

	Malaysia		Change	Philippine		Change
	Pre-IFRS	Post-IFRS		Pre-IFRS	Post-IFRS	
1. Loss Avoidance Ratio (LAR)	3.3	3.7	(0.4)	4.1	3.2	0.9
2. Profit Decline Avoidance Ratio (PDAR)	2	1	1	0	0	0
3. Accrual Ratio (AR)	-0.028	-0.027	(0.001)	0	-0.02	0.02
4. Qualified Audit Opinion Ratio (QAOR)	0.009	0.034	(0.025)	0.05	0.075	(0.025)
5. Non-Big 4 Auditor Ratio (NBAR)	0.44	0.44	0	1	1	0
Total Change of Information Quality	-	-	0.574	-	-	0.895

Notes: LAR = Loss Avoidance Ratio; PDAR = Profit Decline Avoidance Ratio; AR = Accruals Ratio for firm *j* year *t*; QAOR = Qualified Audit Opinion Ratio; NBAR = Non Big 4 Auditors Ratio

3.7 after IFRS adoption, which indicates an increase in earnings management and lower financial information quality after IFRS adoption. The second indicator for earnings management, PDAR, shows a decrease in earnings management and an improvement in financial information quality in Malaysia after IFRS adoption, but no change for firms in the Philippines. The third indicator, AR, shows the same result as the first indicator (LAR) for both countries. This demonstrates a decrease in financial information quality after IFRS adoption for Malaysia (0.001) and an increase in financial information quality for the Philippines after IFRS adoption (0.02).

The other two indicators, QAOR and NBAR, measure financial information quality from an auditing perspective. Similar to the first three indicators, the smaller number of QAOR and NBAR after IFRS adoption indicates higher quality financial information. The “Change” column shows the changes in the indicators measuring financial information quality after IFRS adoption. Positive figures indicate a decrease in the indicators (QAOR and NBAR), which indicates an increase in financial information quality, and vice versa. The results in Table 3 show that QAOR, representing the number of qualified opinion, increases after IFRS adoption in both countries, which indicates a reduction in financial information quality after IFRS adoption from an auditing perspective. At the same time, NBAR, which measures the non-big four auditor ratio, shows no changes before or after IFRS adoption for both Malaysia and the Philippines. The two indicators, QAOR and NBAR, which measure financial information quality from an auditing perspective, indicate that no improvement occurs in relation to financial information quality after IFRS adoption.

The cumulative changes are then calculated for both countries by adding the changes for all five indicators measuring financial information quality. In Malaysia, the cumulative change for earnings management (LAR, PDAR and AR) is positive at 0.599. This result indicates that after IFRS adoption, earnings management is lower and financial information is of higher quality. However, the number of qualified auditor opinions (QAOR) increases, indicating lower financial information quality from an auditing perspective. This, however, could be attributed to the

complexity of IFRS standards (Kim et al. 2012; Yaacob & Che-Ahmad 2012) and not totally due to the quality of the financial information. The fifth indicator (NBAR) indicates that no change occurs between number of Big 4 and non-Big 4 auditing firms before and after IFRS adoption. The result corroborates the contention that the increase in qualified audit opinions could be due to the complexity of the new standards and the cautiousness of auditors in applying the new standards; and not because of the quality of the financial information itself. To summarize, the total changes in all five measurements for Malaysia (0.574) show a positive impact from IFRS adoption in terms of the quality of financial information.

The results in Table 3 depict a similar outcome for the Philippines. The cumulative change for earnings management (LAR, PDAR and AR) in the Philippines is positive at 0.92, indicating an increase in financial information quality. Financial information quality indicators from an auditing perspective (QAOR and NBAR) show similar results to Malaysia (i.e., 0.025 and 0, respectively). To sum up, the total changes in all five indicators for the Philippines is 0.895, indicating a positive impact from IFRS adoption in terms of the quality of financial information. These findings show that the Philippines and Malaysia enjoys the same benefits from IFRS adoption, which culminate in an increase in financial information quality. These results support the first hypothesis that financial information quality in the Philippines and Malaysia increases after IFRS adoption.

The second hypothesis proposes that the impact of IFRS adoption on financial information quality in rules-based countries, such as the Philippines, is greater compared to principles-based countries, such as Malaysia. By comparing the total changes for the two countries (“Total Changes” row in Table 3), the results suggest that financial information quality of both countries increases after IFRS adoption. However, the total change is greater for the Philippines (0.895) than Malaysia (0.576). The result supports the second hypothesis that the impact of IFRS adoption on financial information quality within rules-based countries, such as the Philippines, is more prevalent than principles-based countries.

## ROBUSTNESS TEST

## FINANCIAL REPORTING QUALITY INDEX (FRQI)

To ensure that the findings are robust, one further test is performed by adopting an overall quality index method (Chen et al. 2011; PricewaterhouseCoopers 2001; Tang et al. 2012) to compute the Financial Reporting Quality Index (FRQI). First, the countries are ranked according to the five indicators utilized to measure financial information

quality. Second, for each indicator, the country with the highest value of the indicator is assigned a score of 100 and the score of the second country is calculated as a percentage of the top score (higher score means higher financial reporting quality). Finally, the scores for each indicator are weighted equally (mean) to obtain the FRQI for a country. A higher FRQI means higher rank and, hence, better financial reporting quality. Table 4 presents the results of the test before and after IFRS adoption.

TABLE 4. Financial reporting quality index

	Malaysia				Philippine			
	Pre- IFRS		Post- IFRS		Pre- IFRS		Post- IFRS	
	Indicator	Score	Indicator	Score	Indicator	Score	Indicator	Score
LAR	3.3	100	3.7	93	4.1	88	3.2	100
PDAR	2	80	1	90	0	100	0	100
AR	-0.028	99	-0.027	99	0	100	-0.02	100
QAOR	0.009	100	0.034	100	0.05	99	0.075	99
NBAR	0.44	100	0.44	100	1	94	1	94
FRQI	-	96	-	96.5	-	96	-	98.5

Notes: LAR is the Loss Avoidance Ratio, PDAR is the Profit Decline Avoidance Ratio, AR is the Accruals Ratio, QAOR is the Qualified Audit Opinion Ratio, NBAR is the Non-Big 4 Audit Ratio, FRQI is the financial reporting quality index.

As shown in Table 4, the FRQIs for Malaysia and the Philippines before IFRS adoption are 96. The FRQIs increases after the adoption of IFRS for both Malaysia and the Philippines to 96.5 and 98.5, respectively. This finding supports the earlier conclusion regarding hypothesis one that financial information quality increases after IFRS adoption. The results in Table 4 also show that the improvement in FRQI is higher for the Philippines where it increases from 96 to 98.5. The Malaysian FRQI, on the other hand, only shows a slight improvement from 96 to 96.5. This result, therefore, lends support to the earlier findings concerning the second hypothesis that the impact of IFRS adoption within rules-based countries, such as the Philippines, is more prevalent than principles-based countries.

## ANALYSIS ON THE DATA USED IN THE CALCULATION OF THE INDICATORS

When calculating the indicators, firm-level data are required. For example, in calculating LAR, the total number of firms with small profits is divided by the total number of firms with small losses. Firms with small profits are defined as firms with net income scaled by lagged total assets. Further analysis is performed on the firm-level data to determine whether any significant difference exists between the periods before and after IFRS adoption. The results of the further analysis of the relevant data are shown in Table 5.

TABLE 5. Results of t-test analyses

Indicator	Analyzed Data	Pre-IFRS	Post-IFRS	Sig
Panel A: Results for Malaysia				
LAR	Net income scaled by lagged total assets	3.3	3.7	0.002
PDAR	Change in net income scaled by lagged total assets	2	1	0.000
AR	Accrual quality of firms	-0.028	-0.027	0.000
QAOR	Number of qualified opinion	0.009	0.034	0.000
NBAR	Number of firms that are audited by Big4 auditors	0.44	0.44	0.331
Panel B: Results for the Philippines				
LAR	Net income scaled by lagged total assets	4.1	3.2	0.001
PDAR	Change in net income scaled by lagged total assets	0	0	0.000
AR	Accrual quality of firms	0	-0.02	0.003
QAOR	Number of qualified opinion	0.05	0.075	0.000
NBAR	Number of firms that are audited by Big4 auditors	1	1	0.250

The results in Table 5 indicate that all data sets used to calculate the indicators, except NBAR, are significantly different after IFRS adoption compared to before IFRS adoption. The result concerning NBAR confirms the findings in Table 3 that no change occurs in the level of financial information quality from an audit perspective after IFRS adoption in both countries. Although a significance test cannot be performed on the indicators used to measure financial information quality, the significant changes in the data lend support to earlier conclusions that financial information quality improves after IFRS adoption.

## CONCLUSION

The objective of the present study is to examine whether IFRS adoption increases financial information quality. The results show that financial information quality, measured by the five indicators that can be grouped into two categories, improves after adoption of IFRS. From the earnings management perspective, the results provide evidence that financial information quality improves after IFRS adoption. However, the results from the auditing perspective are mixed. The results of the first indicator from the auditing perspective show that the number of qualified auditor opinions (QAOR) in both countries increases after IFRS adoption, indicating reduced financial information quality. This outcome, however, can be attributed to the complexity of IFRS standards (Kim et al. 2012; Yaacob & Che-Ahmad 2012) and not due to the quality of the financial information itself. Another indicator from the auditing perspective (NBAR) shows that no change occurs in the level of financial information quality in both countries after IFRS adoption. This result corroborates the contention that the increase in qualified audit opinion could be due to the complexity of the new standards as well as the cautiousness of auditors in applying the new standards; and not because of the quality of the financial information itself.

The present study also provides evidence that the impact of IFRSs on rules-based countries is more prevalent compared to its impact on principles-based countries. The results of the present study indicate that the Philippines, which switched from rules-based standards to IFRS, enjoys greater benefits in terms of financial information quality compared to Malaysia, which utilized principles-based standards before IFRS adoption. Extant studies, such as Rankin et al. (2012), note that earnings management is lower under principles-based accounting compared to rules-based accounting. Therefore, earnings management reduction would be more significant after the Philippines switched from rules-based accounting to the IFRS. The contention is supported by the results of the present study.

As reported in Table 6, many countries that have not yet adopted or have only adopted IFRS for specific industries. Among others, authorities in Cuba and Vietnam have not permitted IFRS adoption yet; authorities

in Switzerland permit IFRS adoption, but multinational companies are given the choice to use either IFRS or US GAAP; and authorities in Canada have deferred IFRS adoption for entities with rate-regulated activities, such as utilities companies. The findings of the present study would be beneficial for such countries when they contemplate whether and when to adopt the IFRS (Ahmed, Chalmers & Khlif 2013). The results of the present study suggest that the business environment can be improved by IFRS adoption in the sense that the financial information produced will be of higher quality. This, in turn, will attract the attention of foreign and local investors to participate in the capital market, which will provide capital that is essential to the economic growth of a country. When considering IFRS adoption, such countries should pay attention to their infrastructures, such as fiscal and taxation policies, to ensure a smooth transition because IFRS effects may go beyond financial reporting. Some of the areas that may be affected by IFRS adoption include contract terms; tax policy; financial planning; systems requirements; credit agreements; and compensation structures.

TABLE 6. IFRS adoption in different jurisdictions

IFRSs not permitted	28 jurisdictions
IFRSs permitted	25 jurisdictions
IFRSs required for some	7 jurisdictions
IFRSs required for all	93 jurisdictions

Source: [www.iasplus.com](http://www.iasplus.com) (2012)

The results of the present study also show that accounting standards can play a role in ensuring the quality of financial information produced by firms. In other words, the quality of financial information can be institutionalized through accounting standards. The present study provides evidence that although the IFRS is developed in an environment different from the adopting countries, similar benefits are still enjoyed by the countries that adopt the IFRS. The results suggest that the standards setting bodies, as one of the responsible institutions regulating the business environment, can be entrusted with a greater role in order to ensure richer and better financial information quality.

However, the results of the present study need to be interpreted with caution due to several limitations. First, the present study provides early comparative evidence regarding the impact of IFRS adoption on financial information quality between rules-based and principles-based countries. The sample consists of only one country under each basis. Therefore, further comparative studies in other regions and between other rules-based and principles-based countries should be performed to further understand the impact of IFRS adoption on capital markets and for the findings to be generalized. Second, the present study uses cross-sectional data for one year before and after IFRS adoption. A lengthier period may provide a better picture concerning the outcomes of IFRS adoption.

One year before and after IFRS adoption is chosen because the present study aims to investigate and compare the impact of IFRS adoption between these two countries at first stages of the adoption, regardless of amendments in the following years. Future research can extend the study period to cover more than one year before and after IFRS adoption to better understand the impact of IFRS adoption on the quality of financial information. Third, the results of the present study are based upon data obtained from Malaysia and the Philippines where some IFRS standards have yet to be implemented. For example, IFRS 9 (Financial Instrument) will only become effective in 2015 for all adopting countries. According to Rankin et al. (2012), the alternative implementation strategies used by countries subscribing to IFRSs mean that issues and/or questions will exist concerning whether a particular organization complies with IFRSs issued by the IASB. More research should be conducted in other environments so that the impacts of IFRS adoption in different environments can be revealed.

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#### ENDNOTES

- <sup>1</sup> Code law countries, such as France and Germany, generally have corporate law that stipulates basic legal parameters, one of which often relates to financial statements publication. Any accounting regulations are debated and passed by a national legislature. Common law countries are likely to have non-legislative organizations developing accounting standards. The accounting profession is likely to have less influence on accounting regulations in systems that follow code law.

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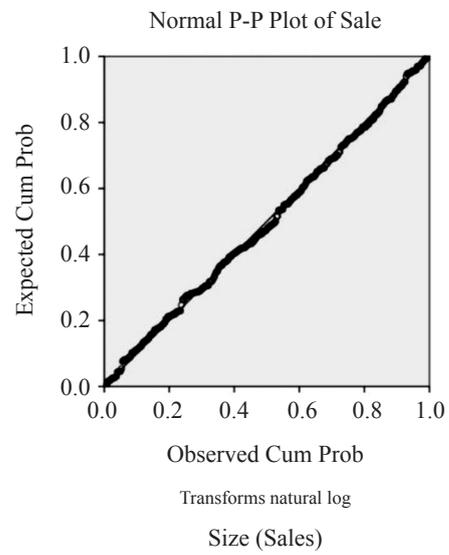
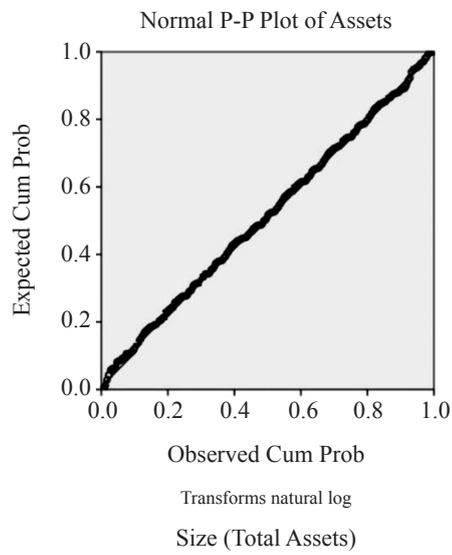
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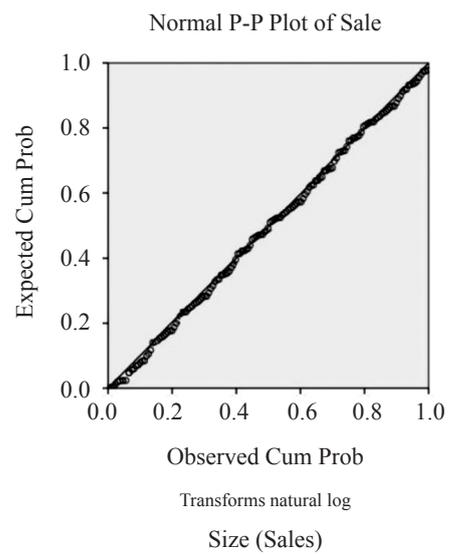
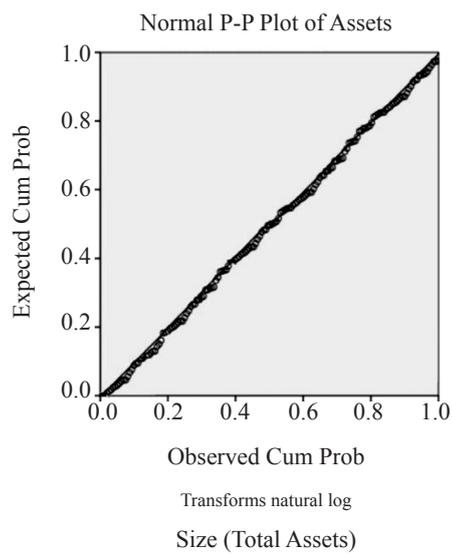
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APPENDIX

Malaysia



Philippine



APPENDIX 1. Distribution of sample