

The Accounting Quality of the Countries in ASEAN after the Declaration of AEC Establishment

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ABSTRACT

The Southeast Asian countries are preparing to be integrated as one economic community and the accounting information will play an important role for trading and capital transferring, both within this region and between Southeast Asia and other regions. However, there are still obvious differences in the domestic accounting standards implemented in each country. This research focuses on the comparison and the effect of International Financial Reporting Standards on the quality of accounting information among 6 countries in ASEAN; Malaysia, Singapore, the Philippines, Indonesia, Thailand, and Vietnam before the integration of the ASEAN economic community (AEC). The accounting quality in this research is measured in terms of earnings smoothing, earnings management toward targets, and timely loss recognition. It is found that the difference in the level of earnings smoothing among countries increased after the declaration of AEC establishment which indicates less comparable. On the other hand, the overall level of earnings management toward targets decreased, which implies that the accounting quality

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improved after the declaration. There is evidence that IFRS has positive effects on the level of earnings management because firms applying more IFRS have less earnings management over time. IFRS adoption helped lowering the level of managing earnings toward targets. Nevertheless, the level of timely loss recognition is not significantly changed after the declaration, and the adoption of IFRS also has no effect on this aspect of quality.

Keywords: Quality, Accounting, ASEAN economic community (AEC)

บทคัดย่อ

กลุ่มประเทศในภูมิภาคเอเชียตะวันออกเฉียงใต้กำลังเตรียมความพร้อมเข้าสู่การรวมตัวกันเป็นประชาคมเศรษฐกิจอาเซียน และข้อมูลทางบัญชีจะเข้ามามีบทบาทสำคัญสำหรับการค้าและการเคลื่อนย้ายเงินลงทุนทั้งระหว่างประเทศภายในภูมิภาคนี้และภูมิภาคอื่น ๆ ทั่วโลก อย่างไรก็ตาม มาตรฐานการบัญชีที่ใช้ในประเทศสมาชิกอาเซียนแต่ละประเทศยังมีความแตกต่างกันอย่างเห็นได้ชัด งานวิจัยนี้มุ่งสนใจการเปรียบเทียบและผลกระทบของมาตรฐานรายงานทางการเงินระหว่างประเทศ (IFRS) ต่อคุณภาพของข้อมูลทางบัญชีระหว่างประเทศสมาชิก 6 ประเทศ ได้แก่ มาเลเซีย สิงคโปร์ ฟิลิปปินส์ อินโดนีเซีย ไทย และเวียดนาม ก่อนการรวมตัวกันเป็นประชาคมเศรษฐกิจอาเซียนหรือ AEC คุณภาพทางบัญชีในงานวิจัยนี้วัดจากระดับของ Earning Smoothing, Earnings Management toward Targets และ Timely Loss Recognition จากผลงานวิจัยพบว่าระดับของ Earning Smoothing ระหว่างประเทศแตกต่างกันมากขึ้นหลังจากการประกาศการก่อตั้ง AEC ในทางกลับกันระดับของ Earnings Management toward Targets โดยรวมลดลง ซึ่งหมายความว่าคุณภาพทางบัญชีสูงขึ้น และมีหลักฐานบ่งชี้ว่าการนำ IFRS มาปรับใช้ส่งผลดีต่อระดับการบริหารจัดการกำไร โดยบริษัทในประเทศที่ปรับใช้ IFRS มากกว่ามีการบริหารจัดการกำไรน้อยกว่า ในทางกลับกันระดับของ Timely Loss Recognition ไม่ได้มีการเปลี่ยนแปลงอย่างมีนัยสำคัญจากผลกระทบของการประกาศการก่อตั้ง AEC ในปี พ.ศ. 2558 และระดับการนำ IFRS มาปรับใช้ไม่มีผลกระทบอย่างมีนัยสำคัญต่อ Timely Loss Recognition

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Southeast Asia was affected by the global financial crisis in 2008 because the economics of the region largely depends on exportation, mostly to other regions. ASEAN economies may be changing fast, but they are still suffering from the crisis. Some of the vital impacts of the global economic crisis on this region are the sharply decelerated export growth and volatile capital

flows. This has left ASEAN member countries a question of how to build regional resilience and ensure sustained growth and stability. Although each country in ASEAN has responded quite well with individual stabilization measures which differ across countries, more coordinated responses are needed for gradual recovery.

In October 2003, there has been a declaration by the ASEAN Charter that the 10 economies of ASEAN are expected to be integrated into one economy as ASEAN Economic Community, or AEC, by the year 2015. Still, the region is facing several challenges for the integration. First, there are concerns that the current crisis might slowdown the regional integration process. However, regional integration should continue in order to provide protection from the global crisis through intra-regional trade. This can help improve regional's competitive strength through open trade, FDI regimes, FTAs, and facilitative environment such as regulatory standards, financing systems, logistics, and business procedure. Second, the increasing cross border financial transactions has raised the importance of ASEAN capital market integration. The ASEAN hopes to learn from the European Monetary Union's experience in many subjects, such as capital flows, cross border mechanism and standardized accounting, to create an environment for integration. Third, there is a need for sustaining regional growth dynamics and monitoring the integration process to keep it on schedule. Financial reporting system takes parts in the challenges of the ASEAN integration. Accounting harmonization is one of the vital facilitators for cross-border flows of goods, services and capital.

According to Sandagaran (1998), accounting harmonization in ASEAN, by adopting International Financial Reporting Standards (IFRS) or International Accounting Standards (IAS), can be beneficial in many ways. For example, comprehensiveness and comparability will assist in promoting intra-ASEAN

trade and investment because financial reporting is an important source of information in ASEAN. Comparability of financial disclosure will reduce the level of information asymmetry between users in these countries and will result in lowering transaction costs. There will be a dissemination of high quality standards and practices. The process of harmonization could assist in creating and sustaining a dynamic environment for change in ASEAN. Moreover, accounting standards' research and development costs are reduced. However, the opponent argues that the harmonization is harmful because of the imposition of accounting concepts and techniques originating in developed countries are inappropriate elsewhere, and it may lead to some hidden costs. Besides, the adoption of IAS does not necessarily imply better quality of financial reporting in ASEAN [Sandagaran and Dija, 1997a].

There are several options for pursuing harmonization, including merging of national standard-setting agencies; following European Union harmonization model; using IASC-based harmonization; or applying free market approach, but there are limitations for every option when applying in ASEAN. The lack of well-developed regional political infrastructure, political machinery or governments support, and effective legal enforcement are the main obstacles especially for the first two options. The International Accounting Standards Committee (IASC) and its successor the International Accounting Standards Board (IASB) have a goal to develop an internationally acceptable set of high quality financial reporting

standards, by using principle-based standards, removing allowable alternatives, and improving accounting measurement. But when coming to the option of using IASC-based harmonization, the issue is that countries that started adopting IAS mostly adopted selectively [Saudagaran and Diga, 1997b] and some countries have not adopted IAS yet. Furthermore, countries in ASEAN still have needs that are specific to the region, such as the joint venture in ASEAN, environment, agriculture, natural resource, and the interrelation between micro accounting and macroeconomic goal.

Although there have been many papers investigating about accounting quality in the European Union (EU) and other developed countries after the IFRS adoption, but their conclusions cannot be applied with ASEAN because there is a difference in economic dependence and organizational structure. Also, ASEAN members are not enforced to fully apply IFRS like EU members do. Even though there are studies arguing that quality of IFRS is higher than most local standards [Leuz and Verrecchia, 2000; Asbaugh and Pincus, 2001; Leuz, 2003; Barth, 2007, 2008], Ball (2003) indicated that high quality standards do not necessarily produce high quality accounting information from the study of five Asian countries. This implies that there are other factors, aside from accounting standards, affecting accounting quality. Soderstrom and Sun (2007) suggest that accounting quality hinges on 3 factors; quality of standards, legal and political system, and financial reporting incentives.

The purpose of this study is to examine three main issues about financial reporting quality in ASEAN; the difference in accounting quality among ASEAN member countries and its relation to the preparation for ASEAN integration; the association between the adoption level of IFRS and accounting quality and the effects of the economic environment on the accounting quality. To examine whether the improvement is related to the preparation of the regional integration, the accounting quality between the period before and the period after the declaration of AEC establishment are compared. It is predicted that the quality should improve after the ASEAN countries are aware of the regional integration. The factors causing the improvement may vary across countries. According to previous studies in European countries, IFRS do have an effect on their earnings quality, either positive [Chen, Tang, Jiang, and Lin, 2010; Barth, Landsman, and Lang, 2008; Van Tendeloo and Vanstraelen 2005] or negative effect [Paananen 2008]. Therefore, the effect of IFRS application in ASEAN, even if it is only partially adopted, is examined by comparing the improvement of accounting quality between two groups of countries. The first group includes countries which have already adopted most of IFRS, and the second group includes countries which have adopted less IFRS and still used their domestic accounting standards. Other firm- and country-level factors are also tested between two periods of time to see whether there is any notable association with the improvement or the degeneration of accounting quality in ASEAN.

The domestic accounting standards vary among the ASEAN members, which may lead to a different level of improvement on financial reporting quality. It is predicted that countries with smaller differences between their domestic accounting standards and IFRS or IAS have better improvement than countries with larger difference. The absence index developed by Ding et al. (2007) is adopted to measure the gap between domestic accounting standards of ASEAN members and IFRS. It measures the extent to which the rules regarding certain accounting issues that required by IFRS are missing in the domestic accounting standards. The accounting differences with IAS are listed in four categories:

1. Accounting may differ from what is required by IAS because of the absence of specific rules on recognition and measurement.
2. No specific rules requiring disclosures.
3. Inconsistencies between national and IAS rules that could lead to differences for many enterprises in certain areas; and
4. In certain enterprises, these other issues could lead to differences from IAS.

Based on these four differences they defined 'absence' to be items from group one or two and 'divergence' to be items from group three or four. All sample countries are then classified into 2 groups; the small-gap group and the large-gap group based on their absence index.

There are two indicators for measuring accounting quality used in this study; earnings management, and timely loss recognition. Higher accounting quality is represented by less earnings

management, and more timely loss recognition. The indications for earnings management are based on earnings smoothing, managing earnings toward targets, and frequency near zero level of return on assets. Earnings smoothing is measured by the volatility of net incomes, more volatility of earnings is interpreted as lower quality. Managing earnings toward targets is measured by the frequency of small positive net incomes, less frequency indicates higher quality. Less frequency near zero level of return on assets indicate higher accounting quality. The indication for timely loss recognition is the frequency of large negative net incomes. Greater frequency of large negative net incomes indicates higher quality. All of the quality metrics in this study are based on prior researches.

The data used in this research is from the publicly listed firms of 8 stock markets; Bursa or MYX, HNX, HOSE, IDX, PSE, SET, MAI, and SGX for the years 1995–2012. The study period is divided into 2 sub periods; the years 1995–2003 which is prior to the official approval of ASEAN integration as AEC, and the years 2004–2012 which is the subsequent period, and both are 9-year periods.

There are 6 ASEAN member countries included in the study; Malaysia, Vietnam, Indonesia, the Philippines, Thailand, and Singapore. The rest member countries are not included because their stock exchanges are not ready for operation at the time of study. The exclusion of financial institutions from the study is consistent with prior studies, due to their particular regulation and disclosure requirements [Penman and Zhang, 2002; Callao and Jarne, 2010]. The study period covers from

Distribution of Firm-Year Observations by country and year

| | Malaysia | Singapore | The Philippines | Indonesia | Thailand | Vietnam | Total |
|--------------|---------------|--------------|-----------------|--------------|--------------|--------------|---------------|
| 1996 | 328 | 187 | 82 | 147 | 203 | - | 947 |
| 1997 | 380 | 201 | 95 | 164 | 222 | - | 1,062 |
| 1998 | 419 | 221 | 99 | 172 | 239 | - | 1,150 |
| 1999 | 426 | 232 | 107 | 174 | 241 | - | 1,180 |
| 2000 | 471 | 268 | 136 | 221 | 247 | - | 1,343 |
| 2001 | 706 | 411 | 179 | 306 | 341 | - | 1,945 |
| 2002 | 810 | 499 | 184 | 316 | 371 | - | 2,180 |
| 2003 | 916 | 631 | 191 | 325 | 400 | - | 2,480 |
| 2004 | 1,025 | 703 | 197 | 332 | 479 | 3 | 2,739 |
| 2005 | 1,093 | 744 | 203 | 341 | 512 | 240 | 3,146 |
| 2006 | 1,139 | 758 | 211 | 367 | 527 | 317 | 3,317 |
| 2007 | 1,171 | 812 | 215 | 380 | 542 | 420 | 3,540 |
| 2008 | 1,207 | 862 | 223 | 412 | 547 | 571 | 3,822 |
| 2009 | 1,225 | 894 | 229 | 439 | 551 | 635 | 3,973 |
| 2010 | 1,235 | 917 | 232 | 455 | 559 | 604 | 4,002 |
| 2011 | 1,240 | 928 | 234 | 456 | 569 | 634 | 4,061 |
| Total | 13,791 | 9,268 | 2,817 | 5,018 | 6,569 | 3,424 | 40,887 |

1996 to 2011, which will be separated into two sub-periods; the period before to the declaration of AEC establishment¹ (1996–2003), and the period after the declaration of AEC establishment (2004–2011).

From the comparison of IFRS with domestic accounting standards in 6 countries in ASEAN, the mean value of absence index is 8.17. Therefore, the countries which absence indexes are less than 8.17 are considered as small-gap countries, and

1 The declaration is in October 2003 and the establishment will expect to be in 2015. (AEC blueprint)

the rest which absence indexes are more than 8.17 are considered as large-gap countries. Small-gap (Large-gap) means there are more (less) adoption of IFRS in domestic accounting standards. The grouping is made as in tables below.

| | Absence Index |
|-----------------|---------------|
| Malaysia | 0 |
| The Philippines | 0 |
| Indonesia | 12 |
| Singapore | 1 |
| Thailand | 13 |
| Vietnam | 23 |
| Mean | 8.17 |

| Small-gap group | Large-gap group |
|-----------------|-----------------|
| Malaysia | Indonesia |
| The Philippines | Thailand |
| Singapore | Vietnam |

The accounting quality differences which may be detected among different countries are attributable to financial reporting system, firms' incentives, and legal and political system. The metrics of quality reflects the effects of the overall economic environment. If the difference is significant, this may lead to the implication that the accounting information in ASEAN is not fully comparable. However, if there is no significant difference, it cannot be concluded whether the accounting quality is high or low. It could only

be inferred that the accounting information is comparable among countries. The improvement or the degeneration in quality should be detected if the announcement of ASEAN integration has an effect on factors associated with accounting quality. As in previous studies, IFRS should have positive effects on quality as it is higher quality standards. The countries with most IFRS adoption should have better improvement or higher quality than countries using more local accounting standards. Nevertheless, the findings may not consistent with the prediction because of two reasons. First, IFRS may be of lower quality than domestic accounting standards because flexibility could provide greater opportunity to manage earnings [Breden, 1994]. Second, the effects of other features could eliminate the improvement from higher quality standards [Cairns, 1999; Street and Gray, 2001; Ball et al., 2003; Burgstahler et al, 2006].

The aspects of accounting or financial reporting quality can be classified into many categories which are based on the reliability and relevance characteristics of financial reporting from International Financial Reporting Standards (IFRS) framework. Accounting quality can be affected by opportunistic discretion exercised by managers and non-opportunistic error in estimating accruals [Barth et al., 2008]. In this study, three main types of indicators will be used to measure accounting quality; earnings management and timely losses recognition. The proxies that will be used in this study are also used in previous studies.

There are two indicators used for measuring earnings management in this study. The first

indicator is earnings smoothing, which consists of three metrics [Chen, Tang, Jiang and Lin, 2010]. The first metric is the variability of the change in net income scaled by total assets, adjusted from Lang, Raedy and Wilson (2006). High variability is consistent with less earnings smoothing [Leuz et al, 2003; Ball and Shivakumar, 2005, 2006; Barth et al., 2008].

The second metric of earnings smoothing is the ratio of the variability of the change in net income to the variability of the change in operating cash flows. It is interpreted that if there is use of accruals to manage earnings, the change in net income should be lower than that of operating cash flows.

The next indicator is managing earnings toward targets [Burgstahler and Dichev, 1997; Leuz, 2003; Burgstahler, 2006; Tang, 2008]. To investigate management towards positive earnings, the coefficient on small positive net income from the regression is used as a metric.

Two indicators above are calculated as the proxies for earnings management. Less earnings smoothing, less frequent management towards targets, or less discontinuity of zero of return on assets would indicate that firms have less earnings management, which will imply a higher financial reporting quality.

According to Watts (2002), conservatism has a productive role in financial reporting providing information to capital market investors. Conservative accounting can help reducing earnings manipulation by management, which can be measured that it increases earnings quality. Timely

loss recognition is one of the measurements of conservatism in accounting and several studies suggest that the timely recognition of large losses is a sign of higher accounting quality [Ball et al., 2000; Ball and Shivakumar, 2005, 2006; Long et al., 2006; Barth et al. 2007, 2008; Chen et al., 2010]. The metric used for measuring timely loss recognition is the coefficient on large negative net income from the regressions.

The questions addressed for this research is whether the accounting quality of the ASEAN member countries less differs after the declaration of AEC establishment, and whether the improvement, if any, of the accounting quality is associated with IFRS adoption in domestic accounting standards which is vary across countries. In the research, the accounting quality is described by the degree of earnings smoothing, managing earnings toward targets, and timely loss recognition. The use of three indicators was intended to help confirm the validity of the results and observe multiple views of quality.

It is found that the degree of earning smoothing of ASEAN countries in the period after the declaration is different from the period before the declaration. Among countries, earning smoothing is not different at the beginning period, but it is significantly different after the declaration. There is less managing of earnings toward targets after the declaration, but not less timely loss recognition in overall ASEAN countries. Countries that adopted more IFRS (Malaysia, Singapore, and The Philippines) tend to have less managing of earnings toward targets than countries that adopted

less IFRS (Indonesia, Thailand, Vietnam), and less managing of earnings after the declaration. On the other hand, the degree of managing earnings toward targets of countries which adopted less IFRS is not lower over time. For the last aspect, the timely loss recognition is not related with the IFRS adoption and the declaration of AEC establishment. Countries which adopted more IFRS does not have more large losses recognition than countries which adopted less IFRS, and also not more large losses recognition after the declaration. This finding suggests the accounting quality of ASEAN member countries more differs among countries after the declaration of AEC establishment. However, there is evidence of accounting quality improvement of overall ASEAN countries. The IFRS adoption also takes parts in the improvement of the accounting quality increase.

However, the difference and the improvement of the accounting quality may not be all attributable to the declaration of AEC establishment and the degree of IFRS adoption. There are also changes in incentives and other economic environment that may be missing from the factors used in this research. Some of the tests used for finding quality metrics reveal not totally consistent results, which cause the difficulty in forming conclusion. This issue is needed to be investigated more by conducting other accounting quality metrics or indicators to verify the validity of this research's conclusions. Furthermore, there is still controversy about the timely loss recognition whether it is a suitable indication for high quality accounting amount.

The recommendation is that the metrics used for the future researches on this topic should be more varied and covered more aspects of accounting quality, such as the magnitude of absolute discretionary accruals; the accruals quality; or other metrics for value relevance aspect, for examples.

This study contributes to the literature examining the quality of financial information in ASEAN. First, the broad sample of firms in almost all countries in ASEAN is used over a long time horizon. Second, multiple measures are used as accounting quality metrics drawn from a common time period and a common set of control variables is conducted. Findings may be inconsistent with prior studies which result from using different metrics, drawing data from different time periods, and using different control variables.

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