Earnings Quality and Value Relevance of Earnings: A Comparison between Pre and Post IFRS Periods in Sri Lankan Context

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Abstract

The introduction of IFRS as a response to the extensive necessity of a common language for financial reporting has opened up new paths for a major line of research area, as the extent of the achievement of the objectives attached with the implementation of IFRS is open to debate all over the world despite its widespread adoption. Accordingly, this study aims to examine the impact on earnings quality and value relevance of earnings on the convergence with IFRS by Sri Lanka by following the global trend of harmonisation of financial reporting practices. The study assesses whether the earnings management practices are significantly low resulting in a higher earnings quality with the adoption of IFRS and whether the value relevance of earnings is significantly higher in the post IFRS period than pre IFRS period with respect to the companies listed in the Colombo Stock Exchange (CSE). The study covers two time periods; three years' period before (pre) and three years' period after (post) the adoption of IFRS. The study employs Dechow et al. (1995) and Kasznik (1999) models to measure the abnormal accruals in order to evaluate the quality of the earnings through earnings management practices. The study then follows the theoretical frameworks of price earnings model and return earnings model as proposed by Ohlson (1995) and Easton and Harris (1991) respectively to assess the value relevance of earnings. The results of the study indicate that the level of earnings management is increased in the post IFRS period indicating a lower level of earnings quality with the adoption of high quality standards of IFRS. Further it finds that the value relevance of earnings is reduced in the post IFRS period than pre IFRS period. The results of the study contribute to fill the existing gap in the literature with respect to the adoption of IFRS by developing countries and frontier markets on the earnings quality and value relevance. The results of the study provide additional evidence to the debate among the researchers on the existence of other significant variables which help to improve the quality of the financial information at individual country level.

Keywords: IFRS, Value Relevance, Earnings Quality, Frontier Market, Sri Lanka

INTRODUCTION

The extensive interest among the researchers on the relationship between accounting information and market data (Holthausen & Watts 2001; Chandrapala 2013; Ball & Brown 1968) has tended to enrich the accounting and finance literature on the earnings quality and value relevance or explanatory power of earnings (Holthausenand & Watts 2001; Kargin 2013; Stunda 2013).

The deterioration of the information contents of accounting information in terms of market data over the past two to three decades (Lev & Zarowin 1999) which was factored with the globalization (Thompson 2016; Shehu & Masunda 2015), technological changes (Shil et al. 2009), worldwide deregulations (Lev & Zarowin 1999) and international financial markets (Callao et al. 2007) has necessitated the need for a common language and motivated the worldwide regulators to formulate a global framework (Macedo et al. 2013; Beuren et al. 2008) to overcome the information asymmetry prevailing with different accounting standards (Beuren et al. 2008) to meet the demand of the users on high quality and value relevant financial information. Accordingly, International Accounting Standards Committee (IASC) and its successor International Accounting Standard Board (IASB) have introduced International Financial Reporting Standards (IFRS/IAS) to spell out the boundaries for preparing and interpreting financial statements (IFRS foundation & IASB 2017) and its use was widespread among both developed and developing countries as their financial reporting framework (PricewaterhouseCoopers 2013).

The completed analysis by IFRS Foundation (2017) in April 2018 on 166 jurisdiction profiles on the use of IFRS around the world, clearly indicates that the IFRS are being used by all parts of the world as shown in the table I;

Table I Analysis of the IFRS jurisdiction profiles

Region	Number of Jurisdictions	Requires IFRS for all or most domestic publicly accountable entities
Europe	44	43
Africa	38	36

Middle East	13	13
Asia and Oceania	34	25
Americas	37	27
Total	**166**	**144**

Source: IFRS foundation (2017)

According to IFRS foundation (2017) around 144 jurisdictions out of 166 require and 12 jurisdictions permit IFRS for all or most domestic publicly accountable entities in their capital market.

This widespread adoption of IFRS has resulted in creating another major line of research (Lourenco &Branco 2015) and importantly, there is a considerable interest among the researchers in assessing the impact on the earnings quality and value relevance following the adoption of high quality standards of IFRS and resulted in mixed findings. However, most of those studies focus on developed countries creating a gap in the literature with respect to the impact of IFRS adoption on the quality of financial information on developing countries (Ismali et al. 2013). Many developing countries have less efficient and immature capital markets (Gibson, 2003 cited in Ismail et al. 2013; Mobarek & Keasay 2000; Black & Nakao 2017), concentrated ownership (Chebaane & Othman 2014; Black & Nakao 2017) and weak institutional and regulatory enforcements (Outa 2011; Mobarek & Keasay 2000; Ding et al. 2007) making the countries more vulnerable to high levels of corruption, insecurity, and conflicts compared to the developed countries (Hartungi 2006). Therefore, existence of significant difference between developing and developed countries in terms of economical, legal and political aspects (Hartungi 2006) emphasises the importance of analyzing the impact of IFRS adoption on the developing countries stating high quality standards would help those countries to improve the quality of financial statements (Ismail et al. 2013).

Creating a remarkable milestone in the area of corporate financial reporting, the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) has issued Sri Lanka Financial Reporting Standards (SLFRS) and Sri Lanka Accounting Standards (LKAS) for annual financial periods beginning on or after 1 January 2012 in line with International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) by following the global trend in enabling

a common language for financial reporting process (The Institute of Chartered Accountants of Sri Lanka 2017 & The Island 2011).

The movement towards the convergence with IFRS is driven with the objectives of more relevant timely and more transparent financial information.

Levitt (1997) states '…Good standards, like good cameras produce sharper, more accurate pictures…' and it is in line with the previous studies which show different levels of earnings quality with different accounting standards (Shil et al. 2009; Soderstom & Sun 2017; Ewert & Wagenhofer 2005). Therefore, it is expected that the adoption of this high quality standard of IFRS would provide a favourable impact on the quality of the earnings reported by the listed companies in Sri Lanka leading to improve the value relevance of earnings.

Therefore, the research question of the study is;

What is the impact of convergence with IFRS by Sri Lanka on earnings quality and value relevance of earnings, being a developing country?

Therefore, this study aims to understand the impact of convergence with IFRS by Sri Lanka as a developing country on the earnings quality and value relevance, by studying three years before the convergence and three years after the convergence.

Accordingly, the following specific research objectives are formulated;

1. To assess the improvement in earnings quality with the adoption of IFRS
2. To assess the improvement in value relevance of earnings in explaining share prices in the post IFRS period
3. To assess the improvement in value relevance of earnings in explaining stock returns in the post IFRS period

The present study examines a different aspect of this important event of global convergence of financial reporting practices since it addresses the peculiarities attached with adopting this high quality global standards by a frontier market like Sri Lanka located in South Asia Region with the characteristics of relatively illiquid and less developed capital market, lower economic development along with the social and political uncertainty. Therefore, this study clearly departs from the previous studies which address the earnings quality and value relevance of earnings in the light of IFRS adoption and complements the literature by filling the existing gap on developing countries by studying the consequences of more direct effect on mandatory

adoption. Further this study would be a useful reference to standard setters, regulators and users of the financial statements to identify the need for further developments with the process and would help in crafting future strategies to improve the effectiveness in the process. Similarly, the result would provide some guidance to the rest of the developing countries with similar institutional characteristics which are interested in switching to IFRS.

LITERATURE REVIEW

The ability of earnings to represent the actual earnings (Bellovary et al. 2005) while having a minor indication of earnings management practices (Lang et al. 2005) is defined as the quality of the earnings. The accounting accrual has gained a considerable attention in measuring the earnings quality recently in the literature (Chan et al. 2006; Nouri & Abaoub 2014) and the total accruals is the difference between earnings and cash flow from operations (Xie 2001). The existence of higher level of abnormal/discretionary accrual which is the amount of accrual above or below the normal accrual, level indicates low earnings quality and lower level of association between share prices (Chan et al. 2006). The level of earnings management practices could also vary according to firm size, growth, profitability and leverage (Rudra & Bhattacharjee 2012; Van Tendeloo & Vanstraelen 2005; Nouri & Abaoub 2014; Collins et al. 2012). The concept of value relevance is one of the interested topics among the researches in the field of accounting and finance from the beginning (Kargin 2013; Holthausen, Watts 2001 & Stunda 2013) and it is defined in the literature as the power of reported earnings to explain the stock prices and stock returns (Ball & Brown 1968; Chandrapala 2013). The literature highlights that a higher earnings quality with lower level of earnings management would lead to improve the value relevance of the earnings (Ismail et al. 2013; Perotti & Wegenhofer 2014). On the other hand, the improvement in value relevance indicates higher quality of the earnings (Chan et al. 2006; Mousa & Desoloy 2014).

In the light of adopting IFRS by the countries all over the world, there is an ongoing debate on whether the changes in accounting would lead to changes in accounting quality (Tsalavoutas et al. 2008) and accordingly it has resulted in bringing new insights in to the issues relating to the quality of accounting numbers and value relevance (Negakis 2013). However, existing studies with respect to the developed countries/markets indicate conflicting evidences on the earnings quality and value relevance of accounting information provided under IFRS against the domestic standards of the particular country.

Nouri and Abaoub (2014) examine the extent of earnings management using the data of 145 French companies listed on the stock exchange covering a ten year period from 2000 to 2009 which is divided into two periods called pre and post IFRS period using modified Jones 1991 model by Kothari et al (2005). Findings of the study indicate that the French companies display significantly less earnings management in post IFRS, with low level of discretionary accruals and has led to higher value relevance. Similarly, the study of Zeghal et al. (2012) confirm an improvement in earnings quality with the adoption of IFRS, reporting a decrease in absolute discretionary accrual through the model of Dechow at al. (1995) using 15 European union countries over the period of 2002 to 2007.

However Ahmed et al. (2013) who study a group of countries in Europe address the accounting quality with the adoption of IFRS highlight that the quality of earnings will improve if the IFRS are of higher quality than that of domestic standards. The study finds a higher level of income smoothing, significant increase in aggressive reporting of accruals leading to inconsistent result indicating a decrease in the accounting quality with the adoption of IFRS.

Further Tendeloo and Vanstraelen (2005) with the data of German listed companies over the period of 1999 to 2001 covering 636 firm-year observations finds no evidence to say that the earnings management is decreased with the adoption of IFRS whereas the discretionary accruals is increased with the IFRS. Similar findings were reported by Macias and Muino (2011) on accounting quality with their study on 15 countries representing full and partial adopters in the Europe including Norway where they have compared financial statements prepared for 2004 with the restated figures in 2005 under IFRS.

The study by Callao et al. (2007) in Spanish companies found no improvement in value relevance with the IFRS adoption. The study highlights that the differences between market values and book values were higher however they predict the value relevance would be recovered and improved in the medium and long run. Similarly, no improvement in value relevance is also confirmed by Kargin (2013) using Turkish listed firms.

Further the study of Negakis (2013) examines the effect of the introduction of IFRS in 2005 on the explanatory power of earnings for stock returns in Greece. The data used in the study consisted from 175 firms listed in Athens Stock Exchange over the period 2000-2007 and used Easton Harris (1991) model. The study indicates that the mandatory use of IFRS after 2005 has a substantial negative effect on the explanatory power of earnings for stock returns. Year-wise regression model also indicates a reduction in the value relevance of earnings and changes in

earnings in the post IFRS period. The implication of the above results is that both book values of equity and earnings lost some of their information content in the post IFRS period leading to decrease the quality of the earnings. Similarly, the study of Paananen and Lin (2009) on German companies for the period from 2000 to 2006 finds a decrease in the value relevance of the earnings in the post IFRS period and further suggests that there is a decrease in the earnings quality in the post IFRS period as well.

The study carried out by Tsalavoutas et al. (2008) examine the relative value relevance of book value of equity and net income of the Greek listed companies among 2004 Greek GAAP versus 2005 IFRS figures in order to check the change in relationship between market values and reported figure before and after the adoption. The study employs Ohlson (1995) as the main model and confirms that there is no change in the relative value relevance of accounting information in pre and post IFRS period. It contributes to the argument that the switching of accounting standards itself is not sufficient to make improvement in accounting quality. The study of the Van der Meulen, Gaeremynck and Willekens (2007) also confirms no significant difference between US GAAP and IFRS prepared financial statement data in terms of value relevance using listed German companies.

When most of the researches focus on individual or only limited number of countries, Barth, Landsman and Lang (2006) in their study address whether the reporting under IAS is associated with higher accounting quality and higher value relevance of accounting amounts following the application of IAS than domestic Generally Accepted Accounting Principles (GAAP) by using a very large sample of 23 countries covering the period from 1994 to 2003. Their study covers the developed countries like Australia, Denmark, Finland, Germany, Hong Kong, Hungary, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey & United Kingdom. The result suggests that firms that apply IAS have higher accounting quality and more value accounting numbers than firms that do not. Further, Kang (2013) through 13 European countries using the earnings return regression models confirms a significant increase in the value relevance. Elbakry et al. (2017) also confirms a higher value relevance of earnings in both Germany and Italy under the Ohlson model using the data of listed companies over a six year period. Garcia et al. (2017) also report an increase in value relevance with respect to companies in Latin America.

The existence of contradictory results even at the studies of the developed countries/markets, doubt the achievement of the objectives of implementing the IFRS by the developing countries.

However, the impact of the adoption of IFRS in developing countries is of little interest up to date.

METHODOLOGY

The phase I of the study evaluates whether the level of earnings management is significantly lower in the post IFRS period leading to higher earnings quality with the adoption of IFRS and phase II of the study examines whether the earnings are more value relevant in the post IFRS period than pre IFRS period. The entire sample period of the study is divided into two periods called; pre IFRS period and post IFRS period. The post IFRS period comprises from financial years beginning in year 2012 to financial years ending in March 2015. Therefore, the pre IFRS period consists of three financial years commenced before year 2012.

Conceptual Framework

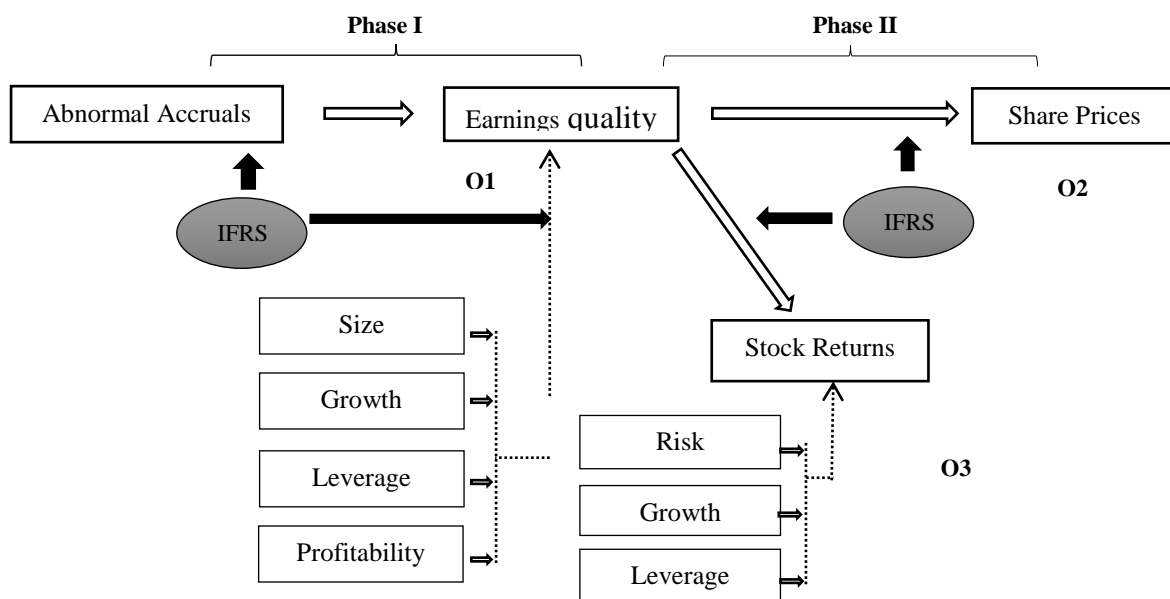The conceptual framework of the study is given in the figure 1.

Figure 1:Conceptual Framework (Source: Ismail et al. 2013)

Model Specification

Phase I: Assessing the Quality of the Earnings in the Pre and Post IFRS Periods:

Dechow et al. (1995) model and Kasznik (1999) model which are commonly used in the literature (Matis et al. 2010; Ismail et al. 2013) are employed in the study to compute the value

of abnormal accrual to assess the earnings management practices. Two alternative models are employed to establish model robustness. The rest of the analysis on the earnings quality is conducted by using the absolute values resulted with the regression representing departure of total accrual from the normal accrual. Low earnings quality is reported with high absolute value of abnormal accruals and vice versa.

Model 01: Dechow et al. (1995)

$$TACCR_{it} = a(1/ASSET_{it-1}) + b(\Delta REV_{it} - \Delta REC_{it}) + cPPE_{it} + \varepsilon_{it} \tag{1}$$

Where $TACCR_{it}$ is the total accruals for firm i in year t, $ASSET_{it-1}$ is the total assets for firm i in year t-1, ΔREV_{it} is the revenue in year t less revenue in year t-1 for firm i, ΔREC_{it} is the receivables in year t less receivables in year t-1 for firm i, PPE_{it} is the gross property, plant and equipment for firm i in year t and ε_{it} is the error term for firm i in year t.

Model 02: Kasznik (1999)

$$TACC_{it} = a(1/ASSET_{it-1}) + b(\Delta REV_{it} - \Delta REC_{it}) + cPPE_{it} + d\Delta CFO_{it} + \varepsilon_{it} \tag{2}$$

Where ΔCFO_{it} is the change in cash flows from operation for firm i in year t relative to year t-1 and all other variables are as previously defined.

In line with Matis et al. (2010) and Kothari et al. (2005), variables used in the above two models are each scaled by previous year total assets to mitigate the estimation errors of the residuals in the regressions.

Following Ismail et al. (2013) the multiple regression equation (3) is estimated on the absolute value of abnormal accrual computed using the above two models in order to check the first hypothesis (H$_1$: 01) of existence of significant improvement in earnings quality in terms of reduction of earnings management practices in post IFRS period than pre IFRS period.

$$ABAC_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 PROFITABILITY_{it} + \beta_3 LEVERAGE_{it} + \beta_4 GROWTH_{it} + \beta_5 IFRS_{it} + \varepsilon_{it}$$
$$(3)$$

Where $ABAC_{it}$ is the absolute value of abnormal accrual for firm i in year t generated from Dechow et al. (1995) model or Kasznik (1999) model, $SIZE_{it}$ is the natural logarithm of total assets for firm i at the end of year t, $PROFITABILITY_{it}$ is the return on asset ratio for firm i in year t, $LEVERAGE_{it}$ is the total long term debt divided by total asset for firm i at the end of year

t, $GROWTH_{it}$ is the share price divided by book value per share for firm i at the end of year t and $IFRS_{it}$ is the dummy variable given a value of 1 if the financial statement prepared under IFRS, 0 otherwise for firm i in year t.

Phase II: Assessing the Value Relevance of Earnings in the Pre and Post IFRS Periods:

Two widely used models in the literature in measuring earnings return relationship called price earnings model (Chebaane & Othman 2014; Kargin 2013; Tsalavoutas et al. 2008; Panaanen 2008; Zeghal et al. 2012) and return earnings model (Alali & Foote 2012;Negakis 2013; Mousa & Desoky 2014; Black & Nakao 2017; Kouki 2018; Kousenidis et al. 2010; Erin et al. 2017) are employed in the study to evaluate the value relevance of earnings in pre IFRS and post IFRS periods.

Price Earnings Model

The Price earnings model which is proposed by Ohlson (1995) is used to test the second hypothesis (H$_1$: 02) of the study on whether there is a significant improvement in the relationship between earnings and share prices in post IFRS period than pre IFRS period.

$$P_{it} = \alpha_0 + \alpha_1 EPS_{it} + \alpha_2 BVPS_{it} + \varepsilon_{it} \tag{4}$$

Where P_{it} is the price of a share of firm i at the year end t, EPS_{it} is the earnings per share of firm i during the year t, $BVPS_{it}$ is the book value per share of firm i at the end of year t and ε_{it} represents the other value relevant information of firm i for year t.

The coefficient of earnings (α_1) explains the ability of firm's earnings to explain stock prices. Further the value of R^2 will be also compared to see the difference in explaining power of the earnings following the IFRS implementation.

In line with Zeghal et al. (2012) and Ismail et al. (2013) the extended regression model (5) is used to assess the interaction of IFRS adoption with the earnings and book values.

$$P_{it} = \alpha_0 + \alpha_1 EPS_{it} + \alpha_2 BVPS_{it} + \alpha_3 IFRS_{it} + \alpha_4 EPS_{it} * IFRS_{it} + \alpha_5 BVPS_{it} * IFRS_{it} + \varepsilon_{it} \tag{5}$$

The coefficient of the interaction variable (α_4) of $EPS_{it}*IFRS_{it}$ indicates whetherthe adoption of IFRS has made a significant influence on the value relevance of earnings in explaining share prices.

Return Earnings Model

The Easton and Harris (1991) return earnings model to test the third research hypothesis (H_1: 03) of existence of significant improvement in the relationship between earnings and stock returns in post IFRS period.

$$RET_{it} = \alpha_0 + \alpha_1 \, EPS_{it}/P_{it-1} + \varepsilon_{it} \tag{6}$$

Where RET_{it} is the holding return for 12 months period before the year end for firm i at year t, EPS_{it}/P_{it-1} is the earnings per share of firm i at the year t divided by the closing price 12 months previously for firm i in year t.

The coefficient of EPS_{it}/P_{it-1} and R^2 of the model are examined to compare the ability of earnings to explain the stock returns in pre and post IFRS periods.

In order to account for the effects of the IFRS implementation on the earnings return relationship equation (6) is augmented by slope and intercepts dummies following Ismail et al. (2013) and Nagakis (2013) by using dummy value of 1 for year 2012 to 2014 (post IFRS period) and 0 otherwise. Along with IFRS variable some other control variables that are highlighted in the literature including the study of Ismail et al. (2013) as important in explaining stock return are also included in the model as follows;

$$RET_{it} = \alpha_0 + \alpha_1 \, EPS_{it}/P_{it-1} + \alpha_2 IFRS_{it} + \alpha_3 \, EPS_{it}/P_{it-1} * IFRS_{it} + \alpha_4 \, EPS_{it}/P_{it-1} * RISK_{it} + \alpha_5 \, EPS_{it}/P_{it-1} * GROWTH_{it} + \alpha_6 \, EPS_{it}/P_{it-1} * TDTA_{it} + \varepsilon_{it} \tag{7}$$

Where $RISK_{it}$ is the β for firm i in year t, $GROWTH_{it}$ is the share price divided by book value per share for firm i at the end of year t, $TDTA_{it}$ is the total debt divided by total assets for firm i at the end of year t and all other variables are as previously defined.

The coefficient of interaction variable (α_3) of $EPS_{it}/P_{it-1}*IFRS_{it}$ of the model captures the impact of IFRS on the value relevance of earnings.

The regressions are run separately for overall period, pre IFRS period and post IFRS period using the basic models (equation 4 and 6) and the extended models (equation 5 and 7) is run on the overall period.

The stock returns are computed by following the comprehensive model proposed by Nimal (2006) with the reinvestment assumption.

Data and Sample Selection

The data used in the study comprises from the companies listed in the Colombo Stock Exchange (CSE) and represents the period from March 2008 to March 2015. However, a number of firms including financial firms (insurance, banks and other financial institutions) are excluded from the sample since they have different explanation on the leverage and different presentation with respect to the financial information to ensure the greater homogeneity in the firms included in the sample following the previous studies on earnings quality and value relevance (Ismail et al. 2013; Nagakis 2013). A number of other firms are excluded from the sample including companies listed in the stock exchange after March 2008 and firms which were non-compliant with the listing rules and firms that do not possess sufficient details. The financial data are gathered from the annual reports and disclosures that are published under each company and other details are obtained from the CSE historical databases.

The exclusion procedure has resulted with 157 firms and accordingly the sample data set for assessing earnings quality which is termed as 'Panel A' represents 538 firm year observations however with respect to the sample data set on 'Panel B' which is used to evaluate the value relevance consist from 512 firm year observations representing only 137 companies due to non-availability of required market data from some companies included under the Panel A.

EMPIRICAL RESULTS

The results are based on the two types of analyses; namely descriptive and inferential including correlations and regressions.

Descriptive Analysis and Correlation

The mean, median, maximum, minimum and standard deviation for the Panel A and Panel B variables used to assess the earnings quality in terms of earnings management and value relevance respectively are determined using descriptive statistics.

The results of the descriptive statistics indicate that there is not much difference between the absolute value of abnormal accrual calculated using Dechow et al. (1995) model leading to ABACDEC value and those computed using Kasznik (1999) model leading to ABACKAS value. The mean and median of ABACDEC is 0.18 and 0.07 respectively whereas the same for ABACKAS is 0.11 and 0.05. A non-parametric test of Wilcogson signed rank test is employed to compare the median values to test whether there is significant difference between the central

tendency measures of median under both models. The test resulted with -1.254 Z value with p value of 0.1049 (one tail test). Therefore, it is not significant at 5 percent level. Similar result is reported with the studies of Ismail et al. (2013) and Martis et al. (2010). However, this is not in line with the studies carried out in the developed countries where they have highlighted the model improvement with the inclusion of variable of changes in cash flow from operations (Pae 2011; Kasznik 1999; McNicholas 2002) which captures the timing and matching problems in cash flows with larger changes in working capital, investment financing activities (Dechow 1994). Therefore, relatively less complex and less dynamic environment in developing countries might have resulted in non-significance of the said variable.

The study measured the degree of association that exists between the variables that are under the study by using the coefficient of correlation using both Pearson's and Spereman's correlation metrics and the matrices prove that the correlations between the variables used in the model are relatively small.

Earnings Quality

The multiple liner regression analysis is employed to evaluate the contribution from each variable that is identified in determining the level of absolute accrual of the firms to evaluate the earnings quality and the results are presented in the Table II.

As indicated in the table the coefficient of the moderate variable of IFRS (β_5) is stood at positive 0.034 (t value 1.204) and 0.023 (t value 1.277) under Dechow et al. (1995) model and Kasznik (1999) model respectively. Similar positive association between IFRS adoption and earnings management under both models suggest that the results are robust to the use of alternative estimation of the absolute value of abnormal accruals. This result suggests that the adoption of IFRS is not associated with lower level of earnings management. In simply the difference between the actual earnings and reported earnings is higher after the adoption of IFRS suggesting that the earnings quality is not improved instead decreased with the adoption of high quality standards even though it is not statistically significant.

The results of the study are consistent with the results of Rudra and Bhattachrjee (2012), Van Tendeloo and Vanstraean (2005) and Santy et al. (2016) which report a positive relationship between earnings management practices with the adoption of IFRS. However, the results of the study are not consistent with the results of Nouri and Abourb (2014) and Ismail et al. (2013)

which have reported significant negative relationship between absolute value of abnormal accrual and IFRS implementation.

The results of the other control variables used in the regression are consistent with the findings of Ismail et al. (2013) conducted in Malaysia except the result of the variable of leverage. Study in Malaysia indicates the significance of leverage (at 5 percent) whereas it is not a significant variable in the context of Sri Lanka which could be due to the comparatively less developed debt market in the country. The studies on African countries reports mixed findings on the earnings quality (Ozili 2016)

It is stated that the accounting standards reflect only one factor which determine the quality of the financial statements whereas there are several other factors representing social, institutional and political environment of a country which are linked as a chain in determining

Table II Regression model of absolute value of abnormal accruals on IFRS and other variables

VARIABLE	CONSTANT		SIZE		PROFITABILITY	LEVERAGE	GROWTH	IFRS

Panel A: Regression results of absolute value of abnormal accrual estimated using Dechow et al. (1995) model

	CONSTANT		SIZE		PROFITABILITY	LEVERAGE	GROWTH	IFRS
Coefficient	-0.489	**	0.044	**	0.021	0.083	0.029	0.034
t-value	-5.809		7.526		0.623	1.059	1.121	1.204
VIF			1.043		1.036	1.061	1.024	1.030
Adjusted R^2	0.101							
F- statistics	13.089	**						
n	538							
Model :	$ABACDEC_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 PROFITABILITY_{it} + \beta_3 LEVERAGE_{it} + \beta_4 GROWTH_{it} + \beta_5 IFRS_{it} + \varepsilon_{it}$							

Panel A: Regression results of absolute value of abnormal accrual estimated using Kasznik (1999) model

	CONSTANT		SIZE		PROFITABILITY	LEVERAGE	GROWTH	IFRS
Coefficient	-0.216	**	0.021	**	0.011	0.025	0.000	0.023
t-value	-4.008		5.746		0.509	0.506	0.196	1.277
VIF			1.043		1.036	1.061	1.024	1.030
Adjusted R^2	0.057							
F- statistics	7.537	**						
n	538							
Model:	$ABACKAS_{it} = \beta_0 + \beta_1 SIZE_{it} + \beta_2 PROFITABILITY_{it} + \beta_3 LEVERAGE_{it} + \beta_4 GROWTH_{it} + \beta_5 IFRS_{it} + \varepsilon_{it}$							

Notes: The full period sample covers from 2009 to 2014 and contains 157 firms with 538 firm year observations. ABACDEC and ABACKAS represents the absolute value of abnormal accruals estimated using Dechow et al. (1995) model and Kasznik (1999) model respectively; $SIZE_{it}$ is the natural logarithm of total assets for firm i at the end of year t; $PROFITABILITY_{it}$ is the return on asset ratio for firm i in year t; $LEVERAGE_{it}$ is total long term debt divided by total assets firm i at the end of year t; $GROWTH_{it}$ is the share price divided by book value per share for firm i at the end of year t; $IFRS_{it}$ is a dummy variable given a value of 1 if the financial statement is prepared under IFRS, 0 otherwise.

**,* significance at 0.05 and 0.10 levels respectively.

the quality of the information (Athanasios et al. 2013). Therefore, though the quality of the standards is a necessary condition, focusing entirely on the quality of accounting standards is not adequate to enhance the quality of the earnings at a particular country level (Ball 2006; Wulandari & Rahman 2004). The above argument is evident with the existing different results of the studies on the mandatory versus voluntary adopters (Paananen & Lin 2009), committed versus label adopters (Daske et al. 2008), the effectiveness of the implementation process (Shil et al. 2009), role of the auditor (Van Tendeloo & Vanstraelen 2005; Malofeeva 2018), internal controls structure (Hastuti et al. 2016) prevailing institutional framework (Haw et al. 2004; Wysocki 2004) and perception about thedomestic GAAP (Hali et al. 2009) and the reporting incentives (Ball et al. 2000; Ball et al. 2003; Nijam & Jahfer 2016). Further it is stated that the existence of unrealized gains and losses along with the practice of fair value accounting has also led to increase the level of abnormal accruals and the impactwould be worse with respect to the developing countries (Ball 2016) due to weakly developed capital market (Samuel 1981 cited in Mobarek & Keasay 2000). Similarly, Barth et al. (2008) highlights the elimination of alternative treatment under IFRS has raised a doubt on the ability of applying accounting measures that are more reliable and realistic with economic performances specific to a company and further states IFRS, being principle-based standards provide more opportunities to manage the earnings which leads to decrease the quality of the earnings.

Value Relevance of Earnings

The results of the multiple regression price earnings model and return earnings model are depicted in the table III and Table IV respectively.

The earnings are regressed with stock prices in terms of earnings per share and book values per share with the price earnings model to evaluate the association between earnings and share prices. The results of the evaluation are shown in the table III.

The coefficient of EPS from the price earnings model before and after IFRS adoption is 1.81 and 1.23 and both are significant at 5 percent level with a *t*-value 3.79 for pre IFRS period and 4.67 for post IFRS period. Further the coefficient of $EPS_{it}*IFRS_{it}$ is negative 0.18 and it is not statistically significant.

The result indicates that the adoption of IFRS has not resulted in increasing the value relevance of earnings in explaining the stock returns and the negative relationship indicates a reduction in the value relevance of earnings in the post IFRS period. The similar result is confirmed with

a negative coefficient of $EPS_{it}*IFRS_{it}$ indicating negative association between adoption of IFRS and value relevance of earnings.

The table III shows that the adjusted R^2 for pooled data is around 41 percent for the entire period whereas the same is around 42 percent for pre IFRS period and 47 for post IFRS period. Therefore, it indicates even with a reduction in value relevance of earnings, the joint model of book values and earnings is capable of explaining more variations in share prices in the post IFRS period.

Though the results of the study are consistent with the findings of Kargin (2013) and Nagakis (2013) highlighting loss of some informational content in the earnings with the adoption of IFRS, the results are not consistent with the findings of Barthov et al. (2002), Ismail et al. (2013) and Chebaane & Othman (2014) who report a positive significant relationship between earnings and stock prices indicating a higher value relevance in the post IFRS period.

The result of the evaluation of relationship between earnings and stock returns which is evaluated through the return earnings model is depicted in the table IV.

As indicated in the table IV adjusted R^2 value for overall period is stood at 1 percent whereas pre and post period account for 2 percent and 0.38 percent respectively. Further the study reports that positive value of 0.27 (significant) for EPS_{it}/P_{it-1} in pre IFRS period whereas same was a negative value of 0.21 (not significant) in the post IFRS period. Further the coefficient of interaction variable $EPS_{it}/P_{it-1}*IFRS_{it}$ is a negative value of 0.54 and significant at 5 percent.

Consistent with the previous model, a negative association between IFRS adoption and value relevance of earnings is confirmed through this model as well. Therefore, the results indicate that the ability of the earnings in explaining stock prices and stock returns has reduced in the post IFRS period than pre IFRS period. Further, the reduction of value relevance with respect to stock returns is statistically significant. The result indicates that the earnings reported under previous standards have a greater value relevance compared to earnings reported in post IFRS period with respect to the listed companies in Sri Lanka.

The results of the study are consistent with the findings of Negakis (2013), Paananen (2008), Zeghal et al. (2011) and Doukakis (2010). However, the results are not inconsistent with the

Table III: Regression on Value Relevance of Earnings using Price Earnings Model

Variable	Pooled Sample (Basic Model)				Pre IFRS (Basic Model)				Post IFRS (Basic Model)				Pooled Sample (Extended Model)			
	Coefficient		t-value	VIF	Coefficient		t-value	VIF	Coefficient		t-value	VIF	Coefficient		t-value	VIF
Constant	26.19	**	8.58		31.36	**	6.51		17.91	**	4.97		31.36	**	7.24	
EPS_{it}	1.71	**	6.5	1.34	1.81	**	3.79	1.60	1.23	**	4.67	1.30	1.81	**	4.22	3.83
$BVPS_{it}$	0.63	**	12.35	1.34	0.79	**	7.92	1.60	0.62	**	11.69	1.30	0.79	**	8.82	4.57
$IFRS_{it}$													-13.45		-2.27	2.10
$EPS_{it}*IFRS_{it}$													-0.18		-1.08	3.96
$BVPS_{it}*IFRS_{it}$													-0.58	*	-1.65	6.33
Adjusted R^2	0.41				0.42				0.47				0.45			
F- statistic	185.61	**			90.83	**			126.64	**			89.27	**		
n	512				249				263				512			

Basic Model: $P_{it} = \alpha_0 + \alpha_1 EPS_{it} + \alpha_2 BVPS_{it} + \varepsilon_{it}$

Extended Model: $P_{it} = \alpha_0 + \alpha_1 EPS_{it} + \alpha_2 BVPS_{it} + \alpha_3 IFRS_{it} + \alpha_4 EPS_{it} * IFRS_{it} + \alpha_5 BVPS_{it} * IFRS_{it} + \varepsilon_{it}$

Notes: P_{it} is the closing price of a share of a firm i at the year end t; EPS_{it} is the earnings per share of firm i during the year t; $BVPS_{it}$ is the book value per share of firm i at the end of the year t, $IFRS_{it}$ is a dummy variable given a value of 1 if the financial statement is prepared under IFRS, 0 otherwise.

**,* significance at 0.05 and 0.10 levels respectively.

Table IV: Regression on Value Relevance of Earnings using Return Earnings Model

Variable	Pooled Sample (Basic Model)			Pre IFRS (Basic Model)			Post IFRS (Basic Model)			Pooled Sample (Extended Model)		
	Coefficient	t-value	VIF	Coefficient	t-value	VIF	Coefficient	t-value	VIF	Coefficient	t-value	VIF
Constant	-0.05 *	-1.75		0.07	1.22		-0.12 **	-4.60		0.07	1.62	
EPS_{it}/P_{it-1}	0.23 **	2.65	1	0.27 **	2.25	1	-0.21	-1.45	1	0.27 **	2.98	1
$IFRS_{it}$										-0.13	-1.40	3
$EPS_{it}/P_{it-1}*IFRS_{it}$										-0.54 **	-1.97	1
$EPS_{it}/P_{it-1}*RISK_{it}$										-0.01	-0.30	2
$EPS_{it}/P_{it-1}*GROWTH_{it}$										0.00	-0.61	1
$EPS_{it}/P_{it-1}*TDTA_{it}$										-0.20	-0.87	2
Adjusted R^2	0.01			0.02			0.0038			0.04		
F- statistic	7.02 **			5.07 **			2.09			4.85 **		
n	512			249			263			512		

Basic Model:

$$RET_{it} = \alpha_0 + \alpha_1\, EPS_{it}/P_{it-1} + \varepsilon_{it}$$

Extended Model:

$$RET_{it} = \alpha_0 + \alpha_1\, EPS_{it}/P_{it-1} + \alpha_2 IFRS_{it} + \alpha_3\, EPS_{it}/P_{it-1}*IFRS + \alpha_4\, EPS_{it}/P_{it-1}*RISK + \alpha_5\, EPS_{it}/P_{it-1}*GROWTH + \alpha_6\, EPS_{it}/P_{it-1}*TDTA + \varepsilon_{it}$$

Notes: EPS_{it}/P_{it-1} is earnings per share of firm i at the financial year t end divided by the closing price 12 months previously for firm i in year t ; $IFRS_{it}$ is a dummy variable given a value of 1 if the financial statement is prepared under IFRS, 0 otherwise; $RISK_{it}$ is the β for firm i in year t ; $GROWTH_{it}$ is the share price divided by book value per share for firm i at the end of year t; $TADA_{it}$ is the total debt to total assets for firm i at the end of year t; RET_{it} is holding return for a 12 months period before the year end for firm i in year t.

**,* significance at 0.05 and 0.10 levels respectively.

findings of Ismail et al. (2013), Alali and Foote (2012) and Uwuigbe et al. (2017) who report a positive significant coefficient for earnings in post IFRS period than pre IFRS period.

The achievements of the benefits of the global standards by all the countries which adopted IFRS were unable to be proven with the available mixed findings in the literature. Furthermore, previous studies highlight the existence of other variables that determine the success of implementation process apart from the quality standards itself.

Despite the long standing debate over fair value accounting it plays a vital role in IFRS and Peng and Bewley (2010) highlight the availability of little evidence and in depth discussionon the ability of developing countries to adapt fair value accounting. Ball (2006) stated that the fair value estimations could be noise and worst with respect to some countries with their relatively illiquid capital markets and Jermakowicz (2004) stated use of fair values brings higher volatility in to the financial information.

Further, Leuz and Wysocli (2008) highlight the ineffectiveness of IFRS on the absence of appropriate capital market and the proper institutional structures to facilitate the process. Ball et al. (2003) emphasise that the availability of preparer incentive towards providing low quality financials with the countries in the Asian Region.

Outa (2011) emphasises the weak institutional framework and economic and political volatility of many developing countries could work against the attached benefits of IFRS.

Therefore, it highlights the importance of building the necessary infrastructure for the effective enforcement mechanism to get the maximum benefit out of these high quality standards to avoid it being another brand that the country borrows which provides small benefits to the users of financial statements. Therefore, a careful analysis is required to assess whether the required effort, timing, and the changes with the convergence process was devoted in the required depth by all the parties engaged throughout the implementation process by Sri Lanka as a developing country.

SUMMARY AND CONCLUSION

The study is carried out with the aim of assessing the impact of convergence with IFRS on the earnings quality and value relevance of earnings in a frontier market like Sri Lanka. Accordingly, this study examines whether the earnings quality after the introduction of IFRS is higher than the pre IFRS period and whether the reported earnings is more value relevant in the post IFRS period.

Findings of the study do not indicate any supportive evidence to state that the earnings management practices by the listed companies are reduced with the adoption of IFRS, instead the study confirms an increase in earnings management practices in the post IFRS period. Therefore, it indicates that the quality of the earnings is not improved with the adoption of the IFRS in the context of Sri Lankan listed companies.

Further results suggest that the adoption of IFRS is unable to improve the value relevance or the explanatory power of earnings with reference to the stock prices, instead it was reduced in the post IFRS period. Similarly, IFRS adoption has not tended to improve the value relevance of earnings on stock returns, instead it tends to decrease the value relevance in the post IFRS period significantly.

Therefore, the findings of the study confirm the existing argument in the literature as put forward by Ball et al. (2003) 'adopting high quality standards might be a necessary condition for high quality information, but not necessarily a sufficient one'.

Even though the test period is consistent with previous studies, it evaluates a relatively short time period and therefore, over a longer period the results could be improved with the improvement in macro environmental setting that builds the necessary infrastructure for effective implementation, familiarity with the process by the parties and with the improvement in implementation guidance of IFRS and thus further studies could extend the period considered in the study.

Further analysis of the reasons for cross country differences of the results on earnings quality and value relevance with the adoption of IFRS would also be a good area for future studies specially with reference to developing countries. This study only focuses on earnings quality and value relevance whereas there are several other variables as suggested by other studies in the literature which are affected with the convergence with IFRS by a country and those would also be areas for future studies.

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