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Original Articles

The impact of IFRS adoption on management of bad debt expense and real operational activities: evidence from South Korea^{*}

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Abstract

This study examines whether the adoption of International Financial Reporting Standards in Korea affects earnings management behavior by focusing on the allowance for doubtful accounts. Adopting IFRS implies a change in approach whereby firms are required to build up an allowance only for incurred losses. Using a sample of 3817 firm-year observations of Korean listed companies covering 2000-2014, I find evidence that the discretionary portion of the allowance is decreased and that the opportunistic management of bad debt expense to meet crucial earnings targets is mitigated after the adoption of IFRS. Further, I find partial evidence that a shift from accrual-based to real earnings management may occur when the management of a specific accrual account is constrained by the adoption of IFRS.

Keywords:

bad debt expense

earnings management

Notes

* Accepted by Jeong-Bon Kim upon recommendation by Haina Shi.

1. The goal of the International Accounting Standards Committee and its successor body the International Accounting Standards Board is to develop an internationally acceptable set of high-quality financial reporting standards. To achieve this goal, they have issued principles-based standards and taken steps to remove allowable accounting alternatives (Barth, Landsman, and Lang <u>2008</u>).

2. The flexibility inherent in principles-based standards could provide greater opportunity for firms to manage earnings, thereby decreasing accounting quality (Ahmed, Neel, and Wang 2013; Barth, Landsman, and Lang 2008; Langmead and Soroosh 2009).

3. The Impairment and Uncollectibility of Financial Assets section of K-IFRS 1039 describes the relevant standards for the recognition of the allowance based on the incurred loss approach. A detailed description of the regulation is presented in Section <u>2.5</u> Hypothesis Development.

4. Some researchers suggest a method of analyzing a specific account because aggregate measures such as discretionary accruals often fail to detect earnings management and thus provide little insight into how it is achieved in practice (Beneish 2001; Marquardt and Wiedman 2004; McNichols and Wilson 1988).

5. The K-IFRS comprises eights IFRS, 29 International Accounting Standards (IAS), 11 Interpretations by the International Financial Reporting Interpretation Committee (IFRIC), and 10 Interpretations by the Standing Interpretations Committee (SIC) (Financial Supervisory Commission <u>2007</u>).

6. K-IFRS 1039 is equivalent to ISA 39.

7. The discretionary portion of the allowance for doubtful accounts can be affected by the management of bad debt expense, the income statement counterpart of the allowance.

8. A difference-in-differences analysis has been used in a number of recent studies on the effects of IFRS adoption in an attempt to address identification problems (Daske et al. <u>2008</u>; Doukakis <u>2014</u>).

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