P-ISSN 2664-0422
O-ISSN 2664-0430

Pakistan Social Sciences Review
www.pssr.org.pk

RESEARCH PAPER

Relationship between Fair Value Accounting Adoption and Financial Reporting Quality

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PAPER INFO

Received:
July 25, 2020
Accepted:
September 05, 2020
Online:
September 30, 2020

Keywords:
Fair Value Accounting Adoption, Financial Reporting Quality, Relevance, Verifiability

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ABSTRACT

The purpose of present research is to assess the impact of fair value accounting adoption while preparing financial reports in financial reporting quality. This study has taken five determinants of financial reporting quality. These determinants are faithful representation, relevance, understandability, comparability and verifiability. Banking sector of Pakistan was chosen and five banks were selected for data collection. Employees who are responsible for preparing financial reports were selected as sample utilizing structured questionnaire. Findings indicate that fair value accounting adoption has positive significance impact on determinants of financial reporting quality specifically, relevance, faithful representation, understandability, comparability. Moreover, results indicate that verifiability is also significantly related with fair value accounting adoption. Findings are beneficial for those financial managers which are responsible to prepare financial report.

Introduction

Fair value accounting adoption techniques is a significant phenomenon these days. Recent financial crisis raises questions on the credibility of financial reporting which is being prepared and published by the companies for investors and stakeholders. Case of Enron is a vital example that company was not in the possession of assets which they were showing in the financial reports. Several studies criticize credibility of data presented in financial reports which are not duly verified, and even most of the data is not according to the current market values. For example, Studies suggested that usage of fair value accounting adoption techniques cannot only present the true picture of the company's assets and liabilities, but it also improves the credibility of financial reporting. For this purpose, a giant audit firm, E & Y presented some qualitative characteristics which can be seen in financial reports to measure its quality. This research is in the continuation of this concept and evaluating these characteristics in the context of Pakistan. Accounting measurement process plays a critical role in preparing multiple financial statements of a firm or any Governing body. The movement towards international accounting standards introduces a new approach in the preparation of financial statements and in defining and reporting financial performance (Bertoni & De Rosa, 2005). According to the Taplin, Yuan, and Brown (2014) since the competition became increasingly severe, the content and mode that the financial report is given to the owners has to be more objective, more standardized, and fairer, thus the need for accounting to adopt real-time measurement mode, and the fair value measurement that best meet the needs of both users of the accounting information and the society for decision making (Tan, 2018). Therefore, the aim of this study is to examine the Fair Value Adoption among Listed Pakistani financial companies.

The historical data and trends have been used for many decades as the prevailing principle for accounting reporting and measurement. Then there was the call for using the fair value for the (IASB) which stands for International Accounting Standards Board and the (FASB) which stands for Financial Accounting Standards Board through the issuance and amendment of many accounting standards whose concept mainly focuses on the fair value accounting (Mangnan, 2015). Without any doubt the nature of historical data and trends are useful when accurate value of the company needs to be determined at the time of acquisition. However, worth needs to be identified using present values because it is imperative to determine the present value of the company at the time of acquisition (Haswell, 2015). At this point, there has been continuous criticism to this principle because the economic situations always undergo constant changing and fluctuating dynamic movement. The purchasing power of currency changes proportionally by the changing situations in the different cases (Guragai, 2015). Therefore, the fair value principle has to be adopted. Moreover, controversy related to the FVA practice got severe attention from pioneers of accounting.

The primary problem in this area is that financial reporting's are not being prepared consistent, and FVA techniques are not being followed. Due to this reason the quality of financial reports is not good. Therefore, investors and auditors find it difficult to understand these reports and take decisions accordingly. Moreover, after substantive literature review, secondary problem found that research in this area is limited in the underdeveloped countries. Hence this research considers this research gap as a problem and aims to fill up the research gap and to conduct this study in the context of Pakistan.

Literature Review

Fair Value Accounting Adoption

The financial reporting's objective is focused on meeting the accounting information needs of the primary user. Laux and Leuz (2010) indicated that the primary user group consists of those who have a claim or potentially may have a claim on the institution's resources. This group include both the institution's present and potential capital investors, creditors, and other lenders.

Fair Value Accounting Adaption and Financial Reporting Quality

According to the observation from historical cost accounting and the fair value accounting, the history of the fair value accounting can be derived. As an example, Pakistan has taken the full advantage of the old version of IAS/IFRS without doing any new changes (Magnan, Menini, &Parbonetti, 2015). The proposed legislation of the specific departments in the Pakistan government, states that the creation of a draft of that legislation begins after the due process is completed. The tax department has taken responsibility for providing the ultimatum to the companies regarding the adoption of the same accounting policies for tax purposes. The creation of the draft includes different meetings within the specific departments, taking expert advice from the higher government officials or from different consultants of the private companies. The company hires different types of consulting agencies, just to provide some extra recommendations if the proper decision making regarding the drafting cannot be successful.

As opinioned by Dignah et al. (2017), the fair value accounting procedure plays a major role in the accounting standards since 1980. The initial involvement of the IAS 16 was to set accounting standards for the plant, pieces of equipment and property (Haswell, 2015). The accounting standard has been collecting the concept of fair value from 1980 to 2008, but due to some inappropriate evaluation in the theoretical adjustments, the proper fair value amount cannot be justified. As per Kane (2016), the IAS 32(1991 version) is the only proper and relevant standard that explained the fair value accounting properly, but it was not put into work as it was not amended.

Fair Value Accounting Adaption and Accounting Information Characteristics

Tan (2018) in his work has highlighted the characteristics as a process of hierarchy for taking effective decisions for the betterment of a business context. The factors that make it important include the different qualities and the proper decision making. The improper decision makers will have an adverse effect on the benefits that are derived from the information. As per Haswell (2015), the accounting information includes the measures such as, the different types of processes used for decision making, the different reliable sources from which the information is gathered, the proper decision to be made and the ability of the users to implement the information properly. The information focuses on the link between the time of crisis and the normal time.

Magnan, Menini, and Parbonetti (2015) analyzed the fair value accounting in the banks which works as a booster which balances the financial cycle. The rise in the credit demand which increases due to the supply of the credit can control the financial cycle which balances the financial statement recorded in the books of accounts in the companies. As stated by Cole et al.(2007), these resources help to state a relationship between the financial value of accounting and the financial crisis, in a global scale. The link between the accounting information and the regulations in baking sector are also recorded.

Characteristics of Accounting Information and Financial Reporting Quality

The purpose of this section is to examine the characteristics that make accounting information useful. Those who prepare, audit, and use financial reports, as well as the Financial Accounting Standards Board, must often select or evaluate alternatives (Sutton & Jenkins, 2007).

The characteristics of information that make it a sought-after commodity can be viewed as a hierarchy of qualities, with usefulness for decision making of most significance. Sutton & Jenkins (2007), noted that the benefits from the information will not be realized without the usefulness to the decision makers. The judgment of any accounting information is based on the factors such as the methods used during the decision making, the decision to be made, the information already possessed from other relevant sources, and lastly the user's ability to process the information.

The hierarchy separates user-specific qualities, for instance, understandability, from qualities inherent in the information. Information can't be valuable to decision makers who can't comprehend it, despite the fact that it might some way or another is significant to a choice and be reliable. However, understandability of information is identified with the attributes of the decision maker and in addition the characteristics of the information itself and, in this manner, understandability can't be assessed in general terms yet must be judged in connection to a particular class of decision makers. Five important characteristics of fair value accounting adaption and accounting information characteristics are Relevance, Faithfull representation, Understandability, Comparability and Verifiability.

Relevance

This characteristic is operationalized using four items referring to predictive and confirmatory value. Researchers (Francis et al., 2004; Lipe, 1990; Schipper & Vincent, 2003) have called relevance as ability of past earnings to predict future earnings.Daske et al. (2008) has described relevance as the positive results from the decision making of the clients that can prove the reliability of accounting information. Meanwhile, this confirmation can help the clients to have expectations of the proper results in the present and future. There can be different types of effects on the decision making the procedure of the clients. This information can include the enhancement of the decision making of the clients or criticism on the older decisions. The information of the past is necessary for forecasting the information in future to be proper. Ahmad and Aladwan (2015) also supports that relevance must include the proper choices which can provide an impact on the ability of the decision makers. If the accounting information is not relevant or it is taking time to gain the information which might be irrelevant for the future, it will be of no use.

Faithfull representation

Faithful representation is the second core qualitative characteristic in Fair Value Adaption and Accounting Information. It represents economic phenomena that annual reports must be completed while keeping the arguments neutral and free from material error. Representational faithfulness is a condition where financial statements should represent real information.

Understandability

Understandability is third important characteristics in Fair Value Adaption and Accounting Information. According to Kane (2016), the ability of the user to evaluate whether the proper information is within the decision-making criteria can be defined as understandability. The information must contain different reliable sources that should properly relate to the different recipients of the financial information. Therefore, as commented by Guragaiet al. (2015), it is essential that the accounting information must be proper so that it can provide a proper effect on the decision making the procedure of the users. The same process of the estimation can secure the unquestionable status of those clients who are self-sufficient; this can be done by securing an improper state of assertion.

Comparability

Another important characteristic in Fair Value Adaption and Accounting Information is comparability, which “is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena”. Accounting comparability is a quality factor in addressing usability of financial information (Cohen et al., 2004). It is considered comparable when it is prepared using the same techniques and similar fashion in reporting it. Information around a specific business gains greatly in value in the event that it can be contrasted and comparable information about different enterprise. Clients ought to have the capacity to look at the money related explanations of a substance over the long haul so as to recognize slants in its monetary position and execution. Clients ought to likewise have the capacity to contrast budgetary information from distinctive elements with evaluate, in relative terms, its money related position, execution and changes in monetary position. An imperative ramification of the particular standard to compare is that customers have to be cultured of the accounting preparations shadowed in the preparation of financial declarations, any changes in these does also the influence of such vicissitudes (Maines &Wahlen, 2006).

Verifiability

The verifiability of the information plays a major role in the represent able quality of the information. As per Bens, Cheng, and Neamtiu (2015), the user does not confirm that the information is verifiable then it would be of no use. The information must be verifiable and equally important for the users to take advantage. The dependability of the users for the information must be met. The representation of the accounting information must be verifiability and presentable to be proper. According to Aleszczyket al. (2019), the scarcity of relevancy and the proper execution of the information can cause harm to the verifiability of the information. The data provided in the accounting information must be presentable with proper details of the information and should provide a positive reply to the questions asked by clients regarding the proper answer that they want to know. As opined by Ahmad andAladwan (2015), the accounting information is dependable on the proper accounting portray and the true estimation of the events or the transactions in the accounting information of the companies. The verifiability is mainly dependable on the exact details provided in the accounting standards represented and mentioned in the accounting information of the companies.

Financial reporting and FVA in Banking sector of Pakistan

Pakistani banks are listed on stock exchange and investors are studying the numbers published by the banks to invest in banks. The banking sector is one of the growing sectors in Pakistan, since the time period of Mr. Shaukat Aziz. During his tenure he gives boom to Pakistani banking industry and urge investors to invest in banking sector to make it profitable industry and contribution in Pakistani economy. Hence it is imperative to study the fair value accounting adoption while preparing financial reports and their quality by using empirical approach.

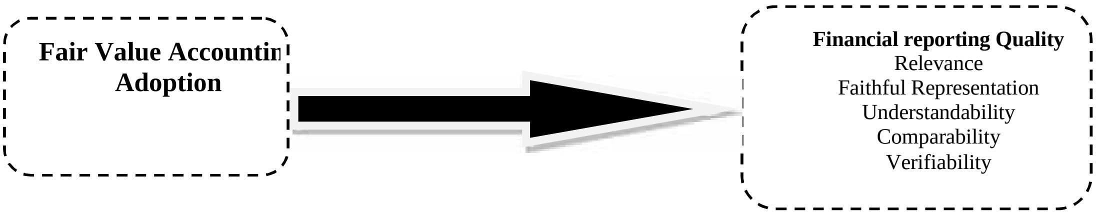
As a result, in Pakistan the focus shifts on discussing the International Accounting Standards that address accounting of the fair value. One of the standards that address accounting of the fair value is the international standard No. 32 that deals with the presentation and disclosure of the financial tools, the international standard No. 36 that is about the diminishing value of assets, the international standard No. 39 that deals with the measurement and confirmation for the financial tools, and the international standard No. 40 about the real estate investment.

It is well known that the financial reports of banks in Pakistan are the main output for their accounting system which lays importance on the figures included in these reports since they sum up quality of interaction and financial transactions during a certain period of time, so these reports have to be useful for Pakistani investor's decisions and helping the existing, potential investors and lenders to estimate and schedule the future cash flows.

However, practical application of preparing the financial reports may face many relevant accounting problems which are concerned with achieving balance in providing the qualitative characteristics of the accounting information whose results are reflected in the corporation's financial lists. For this reason, people concerned with accounting policies already determined the qualitative characteristics for the accounting information which is susceptible to criticism because it does not fit into the digital quantitative estimations and may signify more bias and inconsistency between the essence and the form, thus reducing its credibility and reliability, especially when we look at the criticism routed to the financial lists (Kieso, Weygandt, & Warfield, 2007).

Moreover, one of the qualitative characteristics of the displayed accounting information is that it is clear and easy to understand by users, so the users are supposed to have a reasonable level of knowledge about business, economical, and accounting activities and have the desire to study the information quite carefully (Yen, Lai, &Chen, 2016).

Framework



H1: Fair value accounting adoption is positively related with the relevance of financial reporting quality of Banks in Pakistan

H2: Fair value accounting adoption is positively related with the faithful representation of financial reporting quality of Banks in Pakistan

H3: Fair value accounting adoption is positively related with the understandability of financial reporting quality of Banks in Pakistan

H4: Fair value accounting adoption is positively related with the comparability of financial reporting quality of Banks in Pakistan

H5: Fair value accounting adoption is positively related with the verifiability of financial reporting quality of Banks in Pakistan

Material and Methods

In this study researcher used the deductive research approach as this study is based on empirical evidence. This study is quantitative in nature and data was collected from those financial managers which are responsible for preparing financial reports in the banks of Pakistan. According to (State Bank of Pakistan, 2019), there are total 33 banks operating in Pakistan. Out of those 33, this research has selected five banks randomly, which gives proportionate of 15%, hence five banks are sufficient to generalize results. The target population of this study is financial managers which are responsible for preparing financial reports in the banks of Pakistan. The proposed study aims to make some inferences about impact of fair value accounting adoption in terms of IFRS and IAS methods on the quality of financial reports. The sample size is 133. Although, questionnaire was distributed among 196 but received 133 workable responses. The questionnaire was developed by adapting the pretested scale as under:

Variable	Reference
Fair Value Accounting Adoption	Siam& Abdullatif (2011),Cheng & Neamtiu (2015)
Financial Reporting Quality (Relevance)	Mbobo&Ekpo(2016), Müller (2014), Herath & Albarqi (2017), Kargin (2013)
Financial Reporting Quality (understandability)	Mbobo&Ekpo(2016), Cascini (2011), Barlev (2003), Bens (2015)
Financial Reporting Quality (Faithful Representation)	Cuong (2017).
Financial Reporting Quality (Comparability)	Mbobo&Ekpo (2016),Yen (2016), Yurisandi(2015), Willekens (2008)
Financial Reporting Quality (Verifiability)	Tasios&Bekiaris (2012), Taplin (2014), Schipper (2003), Magnan (2015)

Results and Discussion

The descriptive analysis enables us to understand the deviation in data. For instance, if the standard deviation value is high then the deviation is high from the mean value. The mean is sum of all items divided by the total number of items and it is similar to average. The Descriptive statistics are given in Table 1.

The table 2 shows the beta value, t-value and value of significance. The standard t-value is 2, and standard level of significance is 0.05. The variable value is below 2 it means there is an insignificant relationship, the variable value is above 2 it means there is significant relationship. Similarly, if the value of any variable is negative and below 2 it means there is a negative and insignificant relationship, the variable value is positive and above 2 it means there is positive significant relationship. Multicollinearity was tested by Durbin Watson test and did not found any problem.

If the sig value of a variable is below 0.05 it means there is an insignificant relationship, if the sig value of a variable is above 0.05 it means there is significant relationship.

From the table 2. it can be seen that the t-value of FVAVER verifiability is 7.835 which is higher than 2. Also, the sig is 0.000 which is lesser than standard value of 0.05. So, the results of this variable indicate that there is significant relationship between verifiability which is the dimension of financial reporting quality and fair value accounting adoption. It means fair value accounting adoption is related with the verifiability of the financial reports in the banking sector of Pakistan. From the table 2 we can see that the t-value of relevance is 6.784 which is higher than 2. Also, the value of sig is 0.00 which is lesser than standard value of 0.05. So, the results of this variable indicate that there is significant relationship between relevance which is the dimension of financial reporting quality and fair value accounting adoption. This result means relevance of financial reports of banks should be taken consideration while making investment as it is positively significantly related with the fair value accounting.

Table 1
Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FVAA	133	1.00	5.00	3.6263	.90970
FRQRELV	133	1.00	5.00	3.8246	.97578
FRQUND	133	1.00	5.00	2.3759	1.40311
FRQFR	133	1.00	5.00	3.6541	.93730
FRQCOMP	133	1.00	5.00	3.5921	.98014
Verifiability	133	1.00	5.00	3.21	1.683
Gender	133	1.00	5.00	2.15	.8796
Age	133	1.00	5.00	2.57	.8978
Experience	133	1.00	5.00	2.89	.8635
Designation	133	1.00	5.00	3.55	.8745
Valid N	133				

Regression Analyses

Table 2
Regression Results and Hypotheses Testing

HYP	DV	IV	Unstandardized B VALUE	S. E	T-Stats	F value	R-Square Acct/Rejc
H1	FRQRELV	FVA	.232	0.035	6.784	.000	0.784 ACCEPT
H2	FRQUND	FVA	.436	0.011	2.021	.001	ACCEPT
H3	FRQFR	FVA	.021	0.044	9.904	.000	ACCEPT
H4	FRQCOMP	FVA	.304	0.031	9.385	.000	ACCEPT
H5	FRQVER	FVA	.204	0.009	7.835	.000	ACCEPT

According to the table 2, we can see that the t-value of understandability is 2.021 which is higher than 2. Also, the value of sig is 0.01 which is lesser than standard value of 0.05. So, the results of this variable indicate that there is significant relationship between understandability which is the dimension of financial reporting quality and fair value accounting adoption. This result means understandability of financial reports of banks should be taken consideration while making investment as it is positively significantly related with the fair value accounting. Furthermore, from table 2 we can see that the t-value of faithful representation is 9.904 which is higher than 2. Also, the value of sig is 0.00 which is lesser than standard value of 0.05. So, the results of this variable indicate that there is significant relationship between faithful representation which is the dimension of financial reporting quality and fair value accounting adoption. This result means faithful representation of financial reports of banks should be taken consideration while making investment as it is positively significantly related with the fair value accounting.

However, table 2 shows that the t-value of comparability is 9.835 which is higher than 2. Also, the value of sig is 0.00 which is lesser than standard value of 0.05. So, the results of this variable indicate that there is positive and significant relationship between comparability which is the dimension of financial reporting quality and fair value accounting adoption. This result means comparability of financial reports of banks significant to be taken in consideration while making investment as it is positive significantly related with the fair value accounting.

Conclusion

The stimulus to do this research study is to find out the relationship between fair value accounting adoption and its impact on financial reporting quality and its characteristics in the context of banking sector of Pakistan. The dimensions of financial reporting quality taken are relevance, faithful representation, understandability, verifiability and comparability.

Findings of this study indicate that there is positive significant relationship between fair value accounting adoption and relevance of financial reporting quality. It indicates that if a financial report will contain relevant information, it will be easier for the decision makers to make decision based on that financial report. Findings of this study indicate that there is positive significant relationship between fair value accounting adoption and faithful representation of financial reporting quality. It indicates that if a financial report will contain faithful representation information, it will be easier for the decision makers to make decision based on that financial report. Findings of this study indicate that there is positive significant relationship between fair value accounting adoption and understandability of financial reporting quality. It indicates that if a financial report will contain understandable information, it will be easier for the decision makers to make decision based on that financial report. It is recommended that this research can also be conducted in other sectors which like telecom, insurance companies and other manufacturing industry. Moreover, another recommendation of this study is to use secondary data to analyze the characteristics of financial reporting quality and fair value accounting adoption.

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