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# IFRS Adoption and Earnings Management in Nigerian Non-Financial Quoted Companies

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## Abstract

The study investigated the effects of IFRS adoption on earnings management of non-financial quoted companies in Nigeria. The study utilises a sample of seventy-five non-financial quoted companies in Nigeria that has consistently published their audited annual financial report between 2010 and 2014. A dummy variable was used to separate period of pre and post adoption period; before January 2012 and year-end 2014. The data collected were subjected to descriptive analysis, correlation analysis and a panel multiple regression analysis to explore both trends and possible effects of IFRS adoption on general earnings management. The results established that IFRS adoption in Nigeria does not significantly affects the tendency of Nigerian companies to manipulate earnings. Specifically, the higher audit quality and large firm size does not create a situation where IFRS adoption affects earnings management, this is contrary to the general belief that IFRS, as high quality accounting standards will reduce the possibility of earnings management. By implication, the findings corroborate with arguments that there is no special shield in IFRS that will protect accounts from engineering.

**Keywords:** IFRS, Earnings management, Audit quality, Firm size, Nigerian non-financial quoted companies.

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## 1. INTRODUCTION

Researches in finance and accounting get greater momentum since the universal declaration of IFRS. Approximately more than 120 countries have required or permitted the use of IFRS standards by publicly quoted companies (IASB, 2012). The decision to adopt IFRS in a wide and important economic area such as Nigeria cannot be over – emphasised. However, Nigeria as a developing as well as emerging economies need to give consideration on so many factors that may cause hurdles to smooth adoption as opined by Zeghal & Mhedbi, (2006).

IFRS brought a lot of changes in the way and manner the information contained in the company's financial statement is reported. For instance, the introduction of fair value principle, which is regarded as the most important implication of IFRS. Fair value principle attracts and provokes researchers and generates several debates on the adoption of the standards. More clearly, IFRS required the usage of fair value contrary to the book value as used by Nigerian GAAP. It is believed that fair value provides up-to-date information about assets as it reflects their real value. However, impairment test is carried on goodwill under IFRS, while it expected to be amortized under NGAAP. This implies that managers have more flexibility under IFRS and may intend to use their accounting decisions to manipulate impairment test of goodwill, which could affect the quality of reported earnings. The major concern about the conversion to IFRS is that it is more principle-based and there is

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a fear that the companies may apply the same rules differently thereby causing varying results. Furthermore, principle-based standards give managers more flexibility to engage in earnings management and consequently resulting in high level of earnings manipulation (Callao, 2010).

Thus the very nature of accounting accruals gives managers a great deal of discretion in determining the earnings in any given period. Managers can apply legal and permitted accounting methods or practices which inevitably impacting negatively on earnings quality.

However, this view has not been fully supported by all academicians, regulators and the business communities as their evidence fail to support the hypothesis that IFRS reduce the level of earnings manipulation (Xu 2014; Mara, 2011; Berth, Landsman and Lang, 2008; Stolowy, 2008). IFRS been a principle-based reporting standard are not sufficient condition to reduce the level of earnings manipulation and it is obviously a fundamental fact that IFRS comes with a lot of changes in way and manner the information contained in the company's financial statement are reported and the prior literature have provided mixed evidence on the impact of IFRS adoption. However, the fundamental question that is yet to be resolved in the literatures is: whether the IFRS adoption has significant impact earnings management of Nigerian non-financial quoted companies.

As all the listed firms in Nigeria are mandated to comply with IFRS starting from 1<sup>st</sup> January, 2012, the study covers the 2010-2014. The choice of 2010 to 2014 is based on the ground that we could assign a dummy value of "1" to companies that adopt IFRS between 2010 to 2014 and "0" otherwise. The use of this approach is supported by previous studies (Xu, 2014) and also allow us to correctly assign the value of "0" to companies in Nigeria that did not comply to the mandatory IFRS adoption policy even as at 2012. The study focuses on the listed companies in Nigeria that were expected to comply with IFRS starting from 1<sup>st</sup> January, 2012. Following prior studies (Xu, 2014; Barth, Landsman & Lang, 2008; Houqe, Zijl & Karim 2012; Chua, Cheong & Gould, 2012) we exclude financial institutions. Financial firms are subject to particular financial reporting rules that can influence the earnings management in a different manner.

The broad objective of this study is to examine the effects of IFRS adoption on earnings management of Nigerian non-financial quoted companies. The specific objectives are: to investigate the effect of IFRS adoption on earnings management of Nigerian non-financial quoted companies and to test whether the effect of IFRS adoption on earnings management is influenced by audit quality or firm size of Nigerian non-financial quoted companies.

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## **2. LITERATURE STANCE & THEORETICAL FRAMEWORK**

The study adopts the agency theory and political cost theory to underpin the study. The proponents of agency theory believe that managers are in the best position to minimize the conflicts by strictly pursuing the interest of the shareholders (Fama and Jessen 1988). This holds that managers will not act to maximise the returns to shareholders unless appropriate governance structures are implemented in the large corporation to safeguard the interests of shareholders (Jensen and Meckling 1976). In essence, managers tend to engage in unethical accounting practices through earnings management which negatively impacting on the quality of reported earnings

Political cost theory state that if a company records high profits this might be used as a ground reason for trade unions or lobby groups to take action for an increase in a share of that profit i.e. higher wages, therefore companies may adopt income-decreasing accounting methods (Watts and Zimmerman, 1978). Furthermore, Jones (1991) provides empirical evidence that companies have higher negative discretionary accruals in the period of relieve investigation than the period without investigation. It proves that managers use discretionary accruals in order to report lower earnings when some political investigations occur.

## **3. METHODOLOGY**

The study adopted Correlation and the Ex-post factor Design. The design is considered most appropriate because it describes the statistical relationship between two or more variables.

The population consists of all companies quoted on the Nigerian Stock Exchange as at December 31, 2014. There are 165 quoted active companies (NSE, Factbook 2014) but after excluding 56 financial companies we had 109. A total of 75 non-financial companies were drawn from the population based on the availability of data and the period of IFRS adoption, which represent the sample size for this study. It should be noted that each company in the sampled population must have finished its obligation in delivering annual report for the year ended 2010 to 2014.

### 3.1. Model Specification

In the light of the methodological knowledge gathered and empirical literature in our previous chapters, a panel data multiple regression model is specified. By the dependent variable the study used earnings management measured by discretionary accruals based on modified Jones model. For independent variable we used accounting standards (1 if company adopt IFRS, 0 otherwise), To test whether the effects of IFRS adoption on magnitude of earnings management is influenced by firm size and audit quality, the interaction variables 'IFRS\*SIZE and IFRS\*BIG-4' are included in the model 2 and 3 respectively. Firm size, Audit quality (BIG4), Financial Leverage, Growth and Return on Assets are control variables. To test the three hypotheses, panel multiple regression models with an error term ( $\varepsilon_t$ ) is specified in econometric form as shown below:

$$\text{MODEL 1: } EARM_{it} = \beta_0 + \beta_1 \text{IFRS}_{it} + \beta_2 \text{SIZE}_{it} + \beta_3 \text{BIG4}_{it} + \beta_4 \text{LEV}_{it} + \beta_5 \text{GROWTH4}_{it} + \beta_6 \text{ROA}_{it} + \varepsilon_{it}$$

$$\text{MODEL 2: } EARM_{it} = \beta_0 + \beta_1 \text{IFRS*BIG4}_{it} + \beta_2 \text{BIG4}_{it} + \beta_3 \text{SIZE}_{it} + \beta_4 \text{LEV}_{it} + \beta_5 \text{GROWTH4}_{it} + \beta_6 \text{ROA}_{it} + \varepsilon_{it}$$

$$\text{MODEL 3: } EARM_{it} = \beta_0 + \beta_1 \text{IFRS*SIZE}_{it} + \beta_2 \text{SIZE}_{it} + \beta_3 \text{BIG4}_{it} + \beta_4 \text{LEV}_{it} + \beta_5 \text{GROWTH4}_{it} + \beta_6 \text{ROA}_{it} + \varepsilon_{it}$$

## 4. RESULTS AND DISCUSSION

### 4.1. Statistical Criterion

The results in table 1. Provide of the descriptive statistics analysis of variables, where the minimum, maximum, mean, standard deviations and jarque-bera of the data are fully presented.

Table 1: Descriptive Statistics

| Variables    | Mean     | Max      | Min       | Std. Dev | Jarque-Bera |
|--------------|----------|----------|-----------|----------|-------------|
| EARM         | -0.00025 | 1.03850  | -1.14874  | 0.16812  | 2132.66***  |
| IFRS         | 0.71003  | 1        | 0         | 0.45437  | 72.7920***  |
| AUDIT(BIG4)  | 0.72629  | 1        | 0         | 0.44647  | 77.8218***  |
| SIZE         | 16.1785  | 19.67124 | 11.72637  | 1.66848  | 8.69593***  |
| FLEV         | 57.4166  | 224.1100 | -253.1500 | 30.0428  | 16942.63*** |
| ROA          | 3.864959 | 89.54000 | -101.4200 | 14.0781  | 4383.666*** |
| REVGR        | 9.91019  | 190.4700 | -85.78000 | 29.8016  | 905.2982*** |
| Observations | 369      |          |           |          |             |

Source: Descriptive Statistics Results from Eviews output

Note: \*10% Level of Significance, \*\* 5% Level of Significance, \*\*\*1 % Level of Significance

The results in Table 1. provide some insight into the nature of the selected Nigerian quoted companies that practiced earnings management for the period 2010 to 2014. It shows the mean (average), standard deviation (degree of dispersion), the maximum, minimum and Jarque-Bera (JB) statistics (normality test) for each of the variable. The mean of earnings management practice in our sample is -0.00025. This implies that firms with earnings management below 0.03% would be seen as highly understating their earnings. The minimum and maximum earnings management practice among sampled quoted non-financial companies in Nigeria ranges from -1.14874 to 1.03850 with a deviation of 16.8%.

The result from the descriptive statistics also reveals that audit quality accounted for 73% on the average. This implies that about 73% of the firms selected were audited by the BIG4 (KPMG, PWC, AKINTOLA WILLIAMS DELOITTEE and ERNST and YOUNG) while about 71% of sampled non-financial companies complied with IFRS during the period under consideration. Firm size was measured by the natural logarithm of total assets and has a mean value of 16.1785 with a standard deviation of 1.66848. This implies significant differences across the sample of Nigerian quoted non-financial companies. Financial leverage was measured with the ratio of total debt to total asset and has a mean value of 57.4166 and a standard deviation of 30.0428. This indicated a moderate significant variation among the values of financial leverages of quoted non-financial companies in Nigerian. Return on asset was measured by the ratio of net profit after tax to total assets, and has the mean value of 3.864959 and standard deviation value of 14.0781. The standard deviation of the sampled firms for return on assets was higher than the mean and this could be justified by the losses suffered by some of

the sampled firms. Revenue growth was measured by the percentage change in revenues and has the mean value of 9.91019 and ranges between -85.78000 to 190.4700 at minimum and maximum value respectively, showing the standard deviation value of 29.8016. The standard deviation of the sampled firms for revenue growth was also higher than the mean and this could be justified by the losses suffered by some of the sampled companies.

Lastly, the Jarque-Bera (JB) which test for normality or the existence of outliers or extreme values among the variables shows that all the variables are normally distributed at 1% level of significance. This means that the data collected were free from outlier bias and are reliable for drawing generalization. This also implies that a least square estimation can be used to estimate the regression models.

#### 4.2. Econometrics Criterion

The results of Generalized Least Square regression (Cross-sectional fixed effects) are shown in the Tables below. The regression result of the dependent variable (Earnings management) and the explanatory variables (IFRS adoption, audit, size, leverage, return on assets and revenue growth) are captured in the model 1 of the study. In other to test whether the effects of IFRS adoption on earnings management are influenced by firm size and audit quality, we include an interaction variables IFRS\*SIZE and IFRS\*BIG4 in model 2 and 3 respectively.

Table 2. Summary of Regression Results (Panel Fixed effects)

|                 | Model 1                                  | Model 2                                  | Model 3                                  |
|-----------------|--|--|--|
| C               | <b>-1.6701</b><br>(-3.487)<br>[0.001]*** | <b>-1.7098</b><br>(-3.842)<br>[0.000]*** | <b>-1.7125</b><br>(-3.372)<br>[0.000]*** |
| IFRS            | <b>-0.0015</b><br>(-0.075)<br>[0.940]    |  |  |
| IFRS*BIG4       |  | <b>-0.0075</b><br>(-0.341)<br>[0.733]    |  |
| IFRS*SIZE       |  |  | <b>-0.0003</b><br>(-0.235)<br>[0.816]    |
| SIZE            | <b>0.1021</b><br>(3.329)<br>[0.001]***   | <b>0.0146</b><br>(3.710)<br>[0.000]***   | <b>0.1049</b><br>(3.372)<br>[0.000]***   |
| BIG4            | <b>-0.0114</b><br>(-0.232)<br>[0.817]    | <b>-0.0082</b><br>(-0.165)<br>[0.869]    | <b>-0.0118</b><br>(-0.240)<br>[0.810]    |
| FLEV            | <b>-7.2806</b><br>(-0.016)<br>[0.987]    | <b>-1.8905</b><br>(-0.042)<br>[0.967]    | <b>-0.1005</b><br>(-0.024)<br>[0.981]    |
| REVGR           | <b>-0.0002</b><br>(-0.555)<br>[0.579]    | <b>-0.0002</b><br>(-0.559)<br>[0.576]    | <b>-0.0002</b><br>(-0.560)<br>[0.576]    |
| ROA             | <b>0.0078</b><br>(8.439)<br>[0.000]***   | <b>0.0077</b><br>(8.357)<br>[0.000]***   | <b>0.0078</b><br>(8.414)<br>[0.000]***   |
| R2              | 0.48                                     | 0.48                                     | 0.48                                     |
| Adjusted R2     | 0.34                                     | 0.34                                     | 0.34                                     |
| F-Statistic     | 3.36<br>[0.000]                          | 3.36<br>[0.000]                          | 3.36<br>[0.000]                          |
| Haus test: Chi2 | 28.36<br>[0.000]                         | 31.45<br>[0.000]                         | 29.07<br>[0.000]                         |

Source: Authors computation Eviews output (2015)

From the result in table 2 it can be observed that the R-squared, which is the multiple coefficient of determination, was 0.48 for model 1, 2 and 3 respectively. This means that IFRS adoption, firm size, BIG4 audit firm, financial leverage, revenue growth, return on assets and interaction between IFRS adoption and BIG 4 audit firm and size (IFRS\*BIG4 and IFRS\*SIZE) jointly explained the systematic variations in earnings management practices among the sampled companies in Nigeria to the tune of 48%, while the remaining 52% was caused by factors not captured in the model. The F-Statistics value of 3.36 for model 1, 2 and 3 respectively and their p-values of 0.000 show that the model overall was statistical significant at 1%. This shows that the model is fit and the explanatory variables were carefully selected. However, the three models reveal uniform R<sup>2</sup> as well as Adjusted R<sup>2</sup> with the same level of significance, a good indication of lack of supremacy of either model. This established that IFRS has not in any way help in reducing earnings management in Nigeria.

## 5. CONCLUSION AND RECOMMENDATIONS

In this study, an attempt was made to examine the impact of IFRS adoption on earnings management practices in Nigeria and whether the effects of IFRS adoption are conditional on audit quality and firm size. The empirical research of this study is based on the sample of 68 non-financial quoted companies in Nigerian that has consistently published their audited annual financial report between 2010 and 2014. The dependent variable in this study is earnings management measured by discretionary accruals based on modified Jones model. For independent variables, the study used accounting standards (1 if company adopt IFRS, 0 otherwise), and to test whether the effects of IFRS adoption on magnitude of earnings management is influenced by firm size and audit quality, the interaction variables 'IFRS\*SIZE and IFRS\*BIG-4' are included in the model. Audit quality, firm size, Financial Leverage, Growth and Return on Assets are control variables.

Using a panel data multiple regression model, this study provides strong evidence that IFRS adoption does not significantly affect the tendency of Nigeria companies to manipulate earnings generally. It is specifically documented that high audit quality (BIG-4) does sufficiently created a situation where IFRS adoption affected earnings management. The results reveals that the interaction of IFRS\*BIG4 audit firm does not significantly affect the tendency of Nigeria companies to manipulate earnings. Lastly, the study document that firm size does not sufficiently created a situation where IFRS adoption affected earnings management differently. This implies that the effects of IFRS adoption on earnings management are not different between large companies and small companies.

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