Impact of International Financial Reporting on Earnings Management: Evidence from Nigeria

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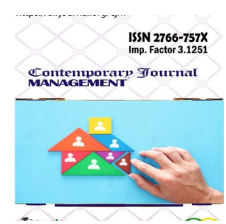Project   ADEQUACY AND LEVEL OF COMPLIANCE IN THE ETHICAL VALUES FOR EFFICIENT PROFESSIONAL ACCOUNTING PRACTICE IN NIGERIA View project

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RESEARCH ARTICLE

Impact of International Financial Reporting on Earnings Management: Evidence from Nigeria

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This research piece centered on the impact of international financial reporting on earnings management. The study utilized discretionary accruals, which were quantified through earnings management, as the dependent variable. International financial reporting standards (IFRS), return on assets, firm size, financial leverage, and audit quality are among the independent variables. OLS Fixed effect model was adopted as suitable for the analysis after several tests, the results shows that IFRS contributed annually to the increase in earnings management.

ABSTRACT

Keywords: *International Financial Reporting; Earnings Management; Nigeria; OLS Fixed Effect Model*

1. Introduction

The globalization of the world economy mandates international standardization of accounting systems to ensure that reporting and transactions across enterprises from different nations are accurate without being restricted by their geographical position. It is anticipated that financial reporting by International Financial Reporting Standards (IFRS) will increase the caliber of the data given in the accounts as well as guarantee the comparability of financial statements from businesses located in various nations. This may be achieved by adopting a flexible worldwide accounting standard that would enable managers and accountants to construct individual financial reporting indicators that would accurately reflect the company's financial situation.

The International Accounting Standards Board (IASB) identifies the relevance and presentation as a basis for qualitative characteristics in financial statements so that they provide beneficial accounting information for investors and other stakeholders when making economic decisions. Management's responsibility to shareholders is also reflected in financial statements because each side attempts to maximize their interests, which may be contradictory, and the separation of ownership and management. the separation of ownership and management in enterprises may produce disputes (He & Sommer, 2010). By bridging the information gap between capital suppliers and those to whom they have entrusted their finances, financial reporting increases accountability. Our Standards provide the information required to hold management responsible. Authorities throughout the globe rely on IFRS Standards as a source of information that is similar across borders. IFRS adoption will limit management's ability to control profitability and increase the accuracy of the information shared. Earnings management is when a company's management utilizes discretionary financial reporting and transaction structure to secure private gains. Earnings management concerns such as financial disclosure and reporting are becoming increasingly important to a wide range of company stakeholders. The principle-based approach and increased mandated disclosure are two of the primary elements of IFRS. Accounting measurements should be more indicative of an entity's economic performance because they must assess its assets and liabilities based on the market's fair value, the use of fair value in IFRS is thought to more properly reflect the firm's status. However, management may be able to opportunistically regulate earnings due to the flexibility in the principal body of IFRS, as well as low IFRS enforcement.

A related difficulty for financial analysts, investors, and corporate leaders is determining how to discern between fraudulent profit manipulation and managers' day-to-day battles to accomplish pre-determined targets by utilizing various accounting flexibilities. Earnings management is the process of making ethically sound management decisions and disclosing them to provide predictable and steady financial results. Most people are aware that a company's earnings are known as net income or net profit. A company's earnings are regarded as the most significant line item on its financial accounts. It's what most analysts employ to assess a company's present situation and future possibilities. Furthermore, the projected value of a firm's share price equals the present value of all of its future earnings, so the value of a company is strongly linked to earnings growth or decline.

Many empirical investigations have indicated that after the adoption of IFRS, the incidence of profit management decreased (Barth, Landsman, Lang, & Williams, 2012). Other research, on the other hand, argues that the introduction of IFRS has no effect on or increases the level of profit management (Tendeloo & Vanstraelen, 2005). The divergent findings could be attributed to the delayed transfer from local accounting standards to IFRS, as well as a lack of infrastructure to implement IFRS. If there are effective laws and regulations protecting enterprises' external partners, management's opportunistic behavior can be avoided. According to Verriest, Gaeremynck, & Thornton (2013) and Pelucio-Grecco, Geron, Grecco, & Lima (2014), regulators argue that although firms adopt IFRS to improve the quality of accounting information, the IFRS also decreases earnings management. As a result, standard-setters and the accounting profession are quite worried about the practice.

In this study, we want to look into how IFRS affects earnings management and engage in earnings management with an improvement in reporting quality.

2. Literature Review

Baiga & Khanb (2016) examined the impact of IFRS on earnings management, comparing pre and post IFRS era in Pakistan. The research was based on a sampling process involving 100 listed companies on Karachi Stock Exchange. The study employed the cross-sectional modified Jones model by Kothari et al. (2005). Regression was employed in testing the hypotheses. The result showed a decline in the use of earnings management which renders ineffective conclusion that, the introduction of IFRS leads to less earnings management.

Rioui, Rigar, & Grine (2020) assessed the impact of international financial reporting on earnings management in Morocco. A logistic regression model was employed in explaining the effect of IFRS adoption in Morocco. A sample of 74 firms listed in the Casablanca Stock Exchange over a period of five years (2010-2015) was adopted, the result showed a convincing evidence that the implementation of IFRS contributed to less earnings management compared to the local accounting standards.

Atoyebia & Simon (2018) studied the impact of international financial reporting on earnings management in the Nigerian banking sector, examining the impact of valuation of Loan Loss Provisions (LLPs) on earnings management and capital management during the pre and post-adoption of IFRS for listed deposit money banks (DMBs) in Nigeria. Ex-post facto research design approach was adopted in explaining the impact of international financial reporting on earnings management in the Nigerian banking sector. The result showed a significant positive relationship between LLPs and earnings management for both pre and post-IFRS adoption.

Malofeeva (2018) investigated the impact of international financial reporting on earnings management in Russia. The study adopted the linear regression model which includes a dependent variable (discretionary accruals), an independent variable (accounting standards) and some control variable, in explaining the impact of international financial reporting on earnings management in Russia. The result showed that IFRS contributes to an increase in earnings management, for companies audited by the Big Four firms.

Kaaya (2015) examined the effectiveness of international financial reporting on earnings management. The study applied a desktop review to investigate the worldwide existing empirical research evidence on the impact of IFRS on earnings management post- IFRS adoption and in relation to other reporting standards and reports whether the results are indistinguishable between developed and developing economies. The findings revealed that, the existing empirical crams and conclusions there on are mixed, inconsistent and difficult to generalise, therefore concludes that, IFRS is a critical determinant for quality reporting but not a 'prima facie' guarantor for quality reporting.

3. Method
A panel data multiple regression model is specified considering the methodological knowledge acquired from the empirical literatures. The study utilized discretionary accruals, which were quantified through earnings management, as the dependent variable. International financial reporting standards (IFRS), return on assets, firm size, financial leverage, and audit quality are among the independent variables. We also evaluated whether the impacts of IFRS on earnings management are influenced by some control variables, such as firm size, return on assets, financial leverage, and audit quality. We employed accounting standards (1 if company adopts IFRS, 0 if otherwise). Panel multiple regression models with an error term are specified in econometric form as follows to test the hypotheses:

$$y_{it} = \alpha + \beta_1(X)_{1t} + \beta_2(X)_{2t} + \beta_3(X)_{3t} + \beta_4(X)_{4t} \dots, +\pi_i + \varepsilon_{it} \dots \dots \dots \dots. (1)$$
$$EG = \alpha + \beta_1(IFRS)_{it} + \beta_2(FM)_{it} + \beta_3(FLEV)_{it} + \beta_4(ROA)_{it} + \beta_4(AUQ)_{it} + \pi_i + \varepsilon_{it} \dots \dots. (2)$$

Dependent Variable:
$(EG)_{it}$ = Earnings management
Predictor Variable:
$(IFRS)_{it}$ = International financial reporting standard
Control Variables
$(ROA)_{it}$ = Return on Assets
$(AUQ)_{it}$ = Audit Quality
$(FLEV)_{it}$ = Financial Leverage

$(FM)_{it}$ = Firm Size

4. Results

4.1 Descriptive Statistics

The descriptive statistics for the variables earnings management, return on assets (ROA), Firm size, IFRS Financial leverage and Audit quality are presented in Table 1 below.

Table 1: Summary Statistics

Indicators	Earning Mgt	ROA	Firm Size	IFRS	Financial Leverage	Audit Quality
Mean	1.69231	5.476	13.648	0.718	47.3166	0.7269
Median	1.76532	4.121	11.123	0.000	17.8531	0.1432
Maximum	23.4112	0.192	19.674	1.000	218.121	1
Minimum	1.00541	0.002	11.726	0.000	-174.98	0
Std. Dev	4.36570	1.023	1.668	0.465	20.0428	0.3374
Skewness	3.02432	2.037	1.032	0.423	0.998	2.4774
Kurtosis	21.0955	7.023	3.700	1.087	2.862	9.5810
Jarque-Bera	144.091	27.90	8.695	67.69	1562.76	66.7209
Probability	0.0000	0.0041	0.0341	0.0026	0.0000	0.0000

As a result, the study's variables had average values of 169.231% for earnings management, 547.76% for ROA, 1364.8% for firm size, 71.8% for IFRS, 4731.66% for FLEV, and 72.69% for audit quality. The median values for each indicator, on the other hand, were as follows: 176.532% for Earnings Management; 412.1% for ROA; 112.3% for business size; 100% for IFRS; 1785.31% for FLEV; and 14.32 % for audit quality. The median values of the variables included in our a nalysis were seen to be quite close to their corresponding mean values. Therefore, 50% of the data used values below the median and 50% of the data used values above the median.

The standard deviation's value points to a more precise and thorough estimation of the dispersion. Additionally, the standard deviation shows how a time series fluctuates. In this regard, the variables financial leverage and earnings management had the highest levels of volatility respectively, while audit quality, IFRS, ROA, and firm size had the least levels of volatility. The positiveness of the skewness in terms of all the variables Earnings management; Return on assets; Firm size; IFRS; Financial leverage and Audit quality shows that all the variables are skewed to the right.

The high significant values of the Jarque-Bera test indicates that our variables of interest were non-normally distributed at the 5% level.

4.2 Panel Unit Root Test

In the case of a panel, the stationarity of each individual series was checked using the unit root test. The alternate hypothesis assumed a stationary series, in contrast to the null hypothesis' assumption of a nonstationary series. In other words, the structure of the mean, variance, and autocorrelation remained constant across the period of time. Through methods like first- or second-order differencing, a stationary time series could be made nonstationary.

$$\Delta Y_t = \beta y_{t-1} + \pi \dots \dots \dots \dots \dots \dots \dots \dots \dots . . (1)$$
$$\Delta Y_t = \alpha_0 + \beta y_{t-1} + \pi \dots \dots \dots \dots \dots \dots \dots \dots . . (2)$$
$$\Delta Y_t = \alpha_0 + \beta y_{t-1} + \alpha_1 + \pi \dots \dots \dots \dots \dots \dots \dots \dots . . (3)$$

To ascertain the stationarity/non-stationarity earnings management and the predictor variables IFRS, ROA, Firm size, financial leverage, and audit quality, we performed a panel unit root test in the table 2 below. When numerous independent components were brought together to make a final regression, the Levin, Lin, and Chu test was useful in this case for doing a unit root test. The findings in Table 2 show that for all the variables, the unit root null hypothesis was rejected. Therefore, we could conclude that the series had no unit root, and it was stationary.

Table 2: Panel Unit Root Test

Variable	Levin, Lin and Chu Test (LLC)				
	Statistic	Prob	Cross section	Obs.	Comments
Earnings Mgt	-4.65182	0.0032	10	130	Stationary at order (0)
IFRS	-7.34786	0.0000	10	130	Stationary at order (0)
ROA	-11.9574	0.0000	10	130	Stationary at order (0)
Firm Size	-2.66574	0.0034	10	130	Stationary at order (0)
Financial leverage	-3.33351	0.0004	10	130	Stationary at order (0)
Audit Quality	-4.00560	0.0000	10	130	Stationary at order (0)

4.3 Pooled OLS, Fixed Effect, and Random Effect Model

Any empirical analysis should begin with the choice of whether to estimate outcomes using a panel regression or a simple regression, according to Baltagi (2008). One should perform a particular test that aids in such a decision for this reason. Since the OLS estimator was unsuitable and inconsistent. EViews results revealed that the null hypothesis—according to which the individual effects were null—had to be rejected. Estimates for the fixed effect model, the random effect model, and the pooled regression are presented in Table 3.

$$\text{EMGT}_{it} = \beta_0 + \beta_1 \text{IFRS} + \beta_2 \text{ROA} + \beta_3 \text{Firm Size} + \beta_4 \text{FLEV} + \beta_5 \text{Audit Quality} + \mu_{it} \dots \dots (4)$$

Table 3: Pooled Model, Fixed and Random Effect Model

Variables	Coefficients	St. Error	t-Statistic	P-value
Pooled Regression				
C	5.423143	2.413246	2.24724	0.0014
IFRS	0.2843210	0.087961	3.23235	0.0413
ROA	0.0001215	0.005342	0.02274	0.7643
Firm Size	0.5394813	0.149876	3.59952	0.0048
Financial leverage	0.0097892	0.287951	0.03399	0.3123
Audit Quality	7.6712651	2.006597	3.82302	0.0013
Fixed Effect Regression				
C	-6.21546	3.878133	-1.6027	0.0065
IFRS	0.341298	0.059731	5.71391	0.0011
ROA	0.000432	0.003123	0.13832	0.0897
Firm Size	0.781986	0.201923	3.87269	0.0039
Financial leverage	0.000091	0.534212	0.00016	0.1271
Audit Quality	4.124390	3.998641	1.03144	0.0476
Random Effect Regression				
C	3.098565	2.512349	1.23333	0.0414
IFRS	0.448564	0.047652	9.41332	0.0001
ROA	0.000331	0.002124	0.15583	0.9713
Firm Size	0.812743	0.239781	3.38952	0.0021
Financial leverage	0.000145	0.336413	0.00043	0.3124
Audit Quality	6.984712	2.993127	2.33358	0.0198

According to table 3, the variable IFRS; Firms size and Audit quality positively influenced the dependent variables of earnings management by 28.4321%; 53.94813% and 76.71265% respectively in the pooled regression. Similarly, these variables also had its influence noted in the fixed and random effect model accordingly. The next step is in choosing between the fixed and random effect model consist of running the Hausman test. In this case, the null hypothesis would imply that the random effect model is consistent. If the null hypothesis is rejected it implies that the fixed effect model would be more adequate. Table 4 below shows the output of the Hausman test.

Table 4: Hausman Test

Test Summary	Chi-Square Statistic		Prob	
Cross section Random			0.1157	
	Fixed Effect	Random Effect	Prob	Observations
IFRS	0.341298	0.448564	0.9123	130
ROA	0.000432	0.000331	0.2142	130
Firm Size	0.781986	0.812743	0.4212	130
Financial leverage	0.000091	0.000145	0.2214	130
Audit Quality	4.124390	6.984712	0.6553	130

As one can see from Table 4, the p-value was above 0.05, therefore, the null hypothesis was not rejected, hence the conclusion that the random effect model is more suitable for the study. According to the random effect model, IFRS contributed annually to the increase in the earnings management, proxied by assigning of dummy variables 1 and 0, with 44.8564%. When considering the controlled variable for this study such as ROA, firm size, financial leverage, and audit quality; only firm size and audit quality contributed annually to the increase in the earnings management of the selected companies.

5. Conclusion

Given a set of superior financial reporting standards, IFRS eliminates many permissible accounting alternatives, and is anticipated to limit the discretion of management in manipulating earnings, thereby improving earnings quality. IFRS has come to stay as the highest financial reporting standard globally, hence encouraged among firms seeking to boost earnings management.

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