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Impact of Changes in Accounting Standard on Earning Management

[1] **Tonye Ogiriki,** [2] **Akpe Sarah Ebimone**

[1, 2] Department of Accounting, Faculty of Management Sciences, Niger Delta University, Wilberforce Island Amassoma, Bayelsa State, Nigeria

Corresponding Author: **Tonye Ogiriki**

Abstract

Through an empirical analysis utilising diverse literature as a foundation for inference, we assessed the impact of recently implemented accounting regulations on the practise of earnings management. The impact of accounting standards on earnings management has been demonstrated statistically. It has been observed that countries that had a pre-existing standard before the implementation of International Financial Reporting Standards (IFRS) tend to exhibit a more effective reporting approach and greater proficiency in managing earnings. Prior literature has not effectively differentiated between ethical and unethical earnings management, as evidenced by the Venn diagrams presented in Chapter 3 of this study. Thus, it is possible to provide guidance to economic resource managers through the utilisation of findings from the literature review.

Keywords: Earning Management, Accounting Standard, Policies

1. Introduction

Over the years, just as man and economic activities change, accounting policies and standards have been seriously dynamic. Therefore, managers of economic resources must keep themselves acquainted with the current standards propounded by the regulatory bodies and international financial reporting standards (IFRS) in order to make themselves relevant to society and the organisation they represent. Every manager of resources strives for different ways of improving the wealth of stakeholders; hence, to achieve the said purpose, they adopt different accounting techniques, and sometimes they engage in earnings smoothing. Earnings smoothing is most common with entities that tie the manager's remuneration to earnings, and many times the managers may display this action in the way they represent the assets in the statement of financial position and in the reporting of the entity's goodwill. Entity managers may take advantage of goodwill because the entity has different ways of reporting its goodwill during acquisition (see IAS 38 and IFRS 3); hence, managers can hide under the said standards of reporting goodwill in trying to smooth earnings. Managers are allowed seven options for reporting acquired goodwill in accordance with IAS 38 and IFRS 3: carrying it as an asset and amortising it over its estimated useful life through the profit and loss account; writing it off against reserves over its estimated useful life; or a combination of these two approaches. Immediately write it off against reserves at purchase; keep it in the books forever unless permanent depreciation is apparent upon impairment recognition; Write it off against earnings in the year you buy it; Deduct it from shareholders' equity (either by amortisation or indefinite carrying) and revaluate it once a year to account for any subsequent, unacquired goodwill (David, Anne, Ann, Martin, & Carien, 2014) [6]. The different scandals experienced by the business world have prompted the emergence of serious standards and policies to regulate the economic activities of companies. Worldcom and Enron, two American economic scandals that rocked the world and left investors reeling, are prime examples of a worldwide controversy. The goal of introducing new or revising existing standards is to rein in unethical profits management by increasing the reliability, comparability, and uniformity of accounting figures across businesses and economies (Anja, 2008).

2. Review of Literature

Earnings consistency at publicly traded Nigerian banks was investigated by Abogun, Olaniyi, Ijaiya, and Fagbemi (2020) [1].There were fifteen (15) different banks included in the analysis of deposit money from 2005 to 2015. The application of the Generalised Method of Moments (GMM) dynamic panel estimate approach revealed that the earnings of Nigerian listed banks exhibit lower levels of persistence, indicating a lower degree of sustainability. In light of this disclosure, it is advisable for investors to exercise prudence and allocate reduced emphasis on the disclosed earnings. Choosing unwisely in the financial realm may be avoided if a sustainable profit level can be established in advance.

In their study, Muhamad, Saleh, and Paridon (2020) [11] analyse the impact of accounting standards on profit manipulation. The researchers also aimed to find out if IFRS-adopting German companies were less likely to engage in earnings management than German GAAP-reporting German companies. Comparing the earnings management success of IFRS-adopters with German GAAP-reporting companies, we evaluated data from two German public enterprises (Südzucker Group and Henkel Group) from 2003 to 2014. This discovery adds to the discourse surrounding the feasibility and relevance of implementing rigorous quality standards in nations with inadequate investor safeguarding laws. German firms that have embraced IFRS have seen a decrease in earnings management, which is associated with the new accounting regulations.

Malofeeva (2018) [10] analysed the frequency with which results were modified before and after IFRS was implemented in Russia. Russian public enterprises across many sectors were included in an accruals-based sample of 361 that was compiled between 2010 and 2015. Discretionary accruals serve as the dependent variable, while accounting standards serve as the independent variable, and the control variables comprise the regression coefficients, demonstrating an increase in profits management in Russia after the introduction of IFRS.

To examine the effect of board composition on the efficacy of profits management, Obigbemi, Omolehinwa, Mukoro, Caleb, and Olusanmi (2016) [12] surveyed 137 publicly listed firms in Nigeria over a period of eight years (2003-2010). A performance-matched version of the Jones model was used to create estimates, with the size of the discretionary accruals standing in for the effectiveness with which profits were managed. Using the OLS regression approach and the Pearson moment correlation coefficient, we tested the hypotheses. Researchers in Nigeria discovered that while board size, gender representation, and board composition all had negative effects on profits management practises, board structure had a favourable influence. Earnings management procedures were also significantly improved as a result of board meetings. The study suggests that in Nigeria, the existence of a compensation committee is associated with improved earnings management practises, although the relationship is not statistically significant. Hence, it is advisable that governmental organisations across all tiers in Nigeria enforce the requirement for the creation and dissemination of yearly financial statements by all enterprises conducting operations within the nation.

In their study, Baig and Khan (2016) [3] assessed the influence of International Financial Reporting Standards on the earnings management practises of publicly traded companies in Pakistan. The sample for the study consisted of one hundred companies that were listed on the Karachi Stock Exchange of Pakistan. The objective of the study was to ascertain whether the quality of accounting information had improved in the post-implementation period of IAS/IFRS, as compared to the pre-implementation period of 2001. Researchers used a cross-sectional adaptation of the Jones model to discover that foreign practises are moving away from US-based GAAP in favour of IFRS. Wage control has thus become more uncommon in many countries. However, this has not occurred in Pakistan for two main reasons: 1) Since Pakistan's inception, the country has operated under an IAS/IFRs-based structure. 2) The data features for assessing IFRS's efficacy are in a consistent format because of 1) because of 1) above. Since the beginning of 2001, however, earnings management has been on the decline. Fewer earnings management strategies have been used since IFRS were adopted between 2001 and 2009, rendering these strategies ineffective.

Onalo, Lizam, and Kaseri (2014) [13] analyse how earnings management at banks in Malaysia and Nigeria changed with the adoption of IFRS-based accounting norms. We analysed information from 23 banks (eight in Malaysia and fifteen in Nigeria) over four years (2009-2012). Through the utilisation of a modified iteration of the Jones model, our study determined that the implementation of both the Malaysian Financial Reporting Standards (MFRSs) and the International Financial Reporting Standards (IFRSs) resulted in an enhancement of the dependability of financial statements produced by banks. This is a proposed modification to require financial statements to be produced and presented using IFRS.

In their 2012 study, Cai, Rahman, and Courtenay examined the impact of the adoption of International Financial Reporting Standards (IFRS) in 31 countries. Their findings revealed that certain nations that implemented IFRS had pre-existing accounting standards that were similar to IFRS, whereas others had accounting standards that were less aligned with IFRS. As a result of the more substantial adjustments necessitated by the implementation of IFRS, we contend that the latter group stands to benefit more from the transition. Countries with IFRS in place, or with accounting norms that are closer to IFRS, also showed less earnings management. Many believe that countries with weaker accounting standards would benefit most from adopting IFRS because it has been found to lead to less profit management in those countries.

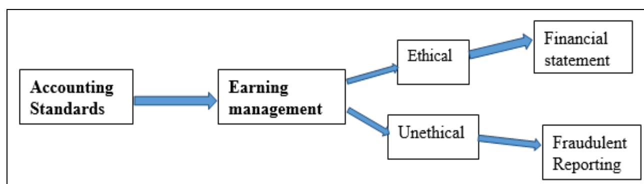
Mate and Navarro (2012) [9] evaluated data from a sample of German firms listed on international stock exchanges over the previous decade to identify a broad pattern of earnings management. This research uses the Seemingly Unrelated Regression (SUR) technique to analyse the profits created by firms' discretionary accruals between 2001 and 2010, with a focus on the mandatory nature of IFRS after 2005. Results demonstrated that the degree of earnings management dropped for a specific time as firms had incentives to implement IFRS, despite the absence of evidence for better financial reporting quality in mandated IFRS adopters following adoption.

Literature Gap

The debate among academics over whether or not to embrace IFRS served as the inspiration for the study. Although many nations have adopted international accounting standards, there is an opposing school of thought that rejects the use of a unified reporting framework. Each economy has its own unique cultural context, which in turn affects economic activity (Kvaal and Nobes, 2010; Oseni, Ireghah, and Ali-Momoh, 2011) [8, 14]. This makes it difficult to establish a common standard for reporting. But other academics, including Antwi (2010) [2] and Beke (2011) [4], to name just two, disagree, arguing that an economy won't benefit from increased comparability or a swell in foreign investment if it adopts IFRS.

3. Changes in Accounting Standards & Earning Management

According to International Accounting Standard No. 8, an entity's accounting policies are the detailed principles, grounds, conventions, regulations, and practises it uses to generate its financial statements. Contrarily, earnings management manipulates financial statements to artificially inflate or "smooth" profits by taking advantage of the way in which accounting standards are enforced. The term "earnings management" refers to the practise of manipulating a company's financial statements via the use of accounting policies and procedures to create an artificially rosy picture of the company's operations and financial health. Any management that stays within the bounds of IFRS and GAAP is fine; anything outside of those rules is problematic. Accounting standards should not be confusing, so that readers and users can simply grasp them, since otherwise resource managers would have a chance to massage the accounting statement. Different methods of profit administration will emerge as a direct result of accounting regulations. The following diagram supports the aforementioned claims:



All of this supports the long-held belief that the needs of the economy are what drive changes in accounting rules. Accounting standards are revised and updated throughout time to ensure they continue to serve the corporate community and the public interest. As a result, there is no universally right way to handle earnings. Ethical financial reporting occurs when managers truthfully report their company's economic activity by taking advantage of accounting loopholes; false financial reporting is a significant financial infraction. There are a variety of motivating factors that can lead to unethical earnings management and, ultimately, false reporting by businesses. "WISE," an abbreviation for "windowhing" and "external expectations," is commonly used to symbolise the driving forces. To name only a few examples, companies that engage in window dressing may use the "cooking jar," "big bath," "changing accounting methods," or "one-time charges" to manipulate financial statements.

4. Is Earning Management Good or Bad?

Earnings management, as described by Jones (2011) [7], comprises adjusting a company's financial records to increase profits or meet some other objective. This is why there is potential value in employing both accounting and non-accounting means to influence earnings qualities. Like goodwill, earnings management may be seen as good if it adheres to the many accounting procedures and standards required by regulatory agencies, and as negative if its primary objective is to deceive investors and achieve personal ambitions at the expense of those of the firm as a whole. Therefore, accounting standards should be reviewed on a regular basis to meet the changing needs of users and, most importantly, to fill in the gaps between current practises and those that have come before.

In order to establish accounting policies for transactions, events, or conditions, it is imperative to apply the relevant standard or interpretation and consider any implementation guidelines issued by the International Accounting Standards Board (IASB) for that particular standard. When making decisions, management should consider the following factors in descending order (IAS 8):

Definitions, recognitions, and valuations of assets, liabilities, income, and costs are all made in accordance with the principles of the framework and the rules and interpretations of the International Accounting Standards Board (IASB) that cover similar or related issues.

In addition to the references indicated in paragraph 11, you may also consider accounting literature, widely recognised industry practises, and other statements from standard-setting organisations that use a conceptual framework comparable to IAS 8.12.

Consistency of Accounting Policies

Accounting policies chosen and used by an entity should be uniformly applied to comparable transactions, events, and situations wherever possible, unless a specific standard or interpretation necessitates or authorises the categorization of things for which alternative policies may be applicable. An suitable accounting policy should be established and consistently implemented to each category if the standard or interpretation demands or enables such classification.

Changes in Accounting Policies

Accounting policy changes are permissible for an entity only under the following conditions:

1. Standardises or interprets as necessary; or
2. Effects on the entity's financial position, financial performance, or cash flows as a result of transactions or other events or situations, as reflected in the financial statements.

The implementation of a policy to a novel transaction or event that has not previously transpired or holds minimal importance is not deemed as an alteration in accounting policy. In the event that a novel standard or interpretation issued by the International Accounting Standards Board (IASB) necessitates a modification in accounting policy, the alteration is documented in compliance with the specifications of the aforementioned pronouncement. Alternatively, if the pronouncement does not comprise any provisions for transition, the change in accounting policy is implemented retrospectively.

The feasibility of retroactively applying an accounting policy change can be achieved through the adjustment of the opening balance of each equity component that has been affected. This adjustment should be made for the earliest prior period, and the corresponding amounts disclosed for each prior period presented should be modified accordingly to reflect the change. When the impact of a modification cannot be ascertained for a particular duration or for several preceding periods, it is incumbent upon the organisation to execute the fresh accounting protocol for the book values of resources and obligations from the earliest period for which retroactive application is viable. During the present time frame, it is necessary for the organisation to make modifications to the initial balance of every impacted element in accordance with the situation. In order to apply the new accounting policy prospectively from the earliest feasible date, the company is required to modify the

comparable information if it is not feasible to determine the cumulative effect of implementing the new accounting policy on all prior periods at the outset of the current period.
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5. Conclusion

We did an empirical study of the impact of new accounting standards on earnings management using a number of different pieces of literature as a foundation for our conclusions. It has been proven that accounting standards have a statistical influence on the management of earnings, and that nations having a standard in place prior to the implementation of IFRS likely to have a more effective reporting style and better earnings management. However, as can be seen in the Venn diagrams presented in Chapter 3 of this study, no previous literature study had been able to clearly distinguish between ethical and unethical earnings management. The literature review's findings include the need of managers of economic resources keeping themselves up to speed on current accounting standards and the requirement for firms to engage in continual training and retraining of staff.

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