Earnings Management and IFRS Adoption – A Study on Selected UK and Indian Pharmaceuticals Companies

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Abstract*: Many countries have adopted International Financial Reporting Standard (IFRS) as their primary standards for their preparation of corporate accounts. Despite this wide spread adoption some countries as India still followed IFRS on voluntary basis. IFRS promises more accurate comprehensive and timely financial statement information. IFRS considers investors as the main users of financial statements. IFRS often represents tighter accounting standards as compared to local Generally Accepted Accounting Principle(GAAP), which therefore limits managerial discretion and possibility for Earnings Management based on accrual manipulation.*

The purpose of this paper is to find out the impact of adoption of IFRS on practice of earnings management. We took pharmaceuticals companies from UK and India to compare the impact of IFRS on earnings management as Pharmaceuticals companies from UK follow IFRS.

The result of our study supports that there is existence of earnings management practice. As per our analysis the implementation of IFRS is limiting the earnings management which is generated by using managerial discretion.

Keywords*: IFRS, Earnings management, Discretionary accruals, GAAP*

I. INTRODUCTION

Governments and markets use various mechanisms to reduce earnings management. The most notable are accounting standards. Accounting standards provide different accounting choices, and therefore their application may result in earnings of different quality.

A goal of the International Accounting Standards Committee (IASC), and its successor body the International Accounting Standards Board (IASB), is to develop an internationally acceptable set of high quality financial reporting standards. To achieve this goal, the IASC and IASB have issued principles-based standards, and taken steps to remove allowable accounting alternatives and to require accounting measurements that better reflect a firm's economic position and performance. Accounting quality could increase if these actions by standard setter's limit management's opportunistic discretion in determining accounting amounts, for example, by managing earnings.

Many countries have adopted International Financial Reporting Standard (IFRS) as their primary standards for their preparation of corporate accounts. Despite this wide spread adoption some countries as India still followed IFRS on voluntary basis. IFRS promises more accurate comprehensive and timely financial statement information. IFRS considers investors as the main users of financial statements. IFRS often represents tighter accounting standards as compared to local Generally Accepted Accounting Principle, which therefore limits managerial discretion and possibility for Earnings Management based on accrual manipulation.

The main purpose of this paper is to examine the existence of earnings management between companies those following International Financial Reporting standard (IFRS) and the companies yet to adopt IFRS for their financial reporting.

II. LITERATURE REVIEW

A number of qualitative studies have analysed the latitude of accounting choices. Several studies analyse the effect of all accounting rules embedded in an accounting framework on the quality of financial statements in a single economy. Leuz and Verrecchia (2000), Leuz (2003) and Bartov et al. (2005) use different market measures of financial statement quality to compare financial reports of German listed companies prepared under different accounting regimes.

Van Tendeloo and Vanstraelen (2005) use the concept of earnings management to test the effect of latitude of accounting standards on the properties of reported earnings. The results of these studies are mixed.

Leuz (2003) finds no difference in the bid ask spreads and the share turnover (proxies for information asymmetry) between US GAAP and IAS sub-samples of firms listed on the German's Neuer Markt. Van Tendeloo and Vanstraelen (2005) also point to no effect of accounting standards on the properties of reported earnings by finding similar levels of earnings management under German GAAP and IAS. On the other hand, Bartov et al. (2005) conclude that earnings are more value relevant under the international frame work (i.e. IAS or US GAAP) than under German GAAP and that US GAAP earnings have similar relevance as IAS earnings after controlling for self-selection.

A study by Daske and Gebhardt (2006) shows a significant increase in disclosure quality, and greater comparability and transparency when financial statements are prepared under IFRS for firms from Austria, Germany and Switzerland. Callao and Jarne (2010) examines whether the scope of discretionary accounting practices by EU firms changes following the regulatory change to IFRS. For 1,408 firms from 11 EU countries, their results indicate that discretionary accruals increase after the mandatory implementation of IFRS, and appear to confirm that principles-based accounting leaves more scope for earnings management than rule-based accounting.

Objectives

The objectives of this paper are

1. To study the existence of the earnings management in the sample companies
2. To compare the intensity of existence of earnings management between companies following IFRS and companies not following IFRS.

III. RESEARCH METHODOLOGY

Sample: The comparison is made between pharmaceuticals companies where IFRS is followed i.e. pharmaceuticals companies from UK or not i.e. pharmaceuticals companies from India. We chose pharmaceuticals sector randomly for analysis of the effects of IFRS on earnings management.

We took two sets of samples for the study. The sample consists of 6 top pharmaceuticals companies. Out of these 3 companies namely Dr. Reddy's, Cipla and Sun pharmaceuticals belongs to nifty 50 indices (India) and the other 3 companies namely AstraZeneca, GlaxoSmithKline and Shire plc. belongs to FTSE 100 (UK).

Sources: Data is collected from annual reports of the respective companies and from website ("http:// ican.tddirectinvesting.co.uk/") for 5 years from 2011 to 2015.

Methodology: Discretionary accrual has been used as proxy for detecting earnings management. For calculating total accruals cash flow statement approach has been used.

$$TA_{it} = NI_{it} - CFO_{it}$$

Where TA= Total accrual

NI= Net income

CFO= Cash flow from operation

For calculating Discretionary part of accruals, we used regression model suggested by Dechow et al. popularly known as modified Jones model. The model is as follows

$$DA_{it} = TA_{it} - [\alpha_1 (1/A_{t-1}) + \alpha_2 \{(\Delta REV_{it} - \Delta REC_{it})/ A_{t-1}\}] + \alpha_3 (PPE_{it}/ A_{t-1})]$$

Where: TA = total accrual

ΔREV= change in revenue

ΔREC= change in receivables

PPE= gross of plant property and equipment

A_{t-1}= is total of assets at the end of year t-1

For evaluating the impact of IFRS on financial disclosure and earnings quality, we match the results derived from the above model for the two sets of samples. We took the average of sample companies of each sample years for comparison.

IV. RESULTS AND FINDINGS

For the analysis of data spss16.0 software has been used.

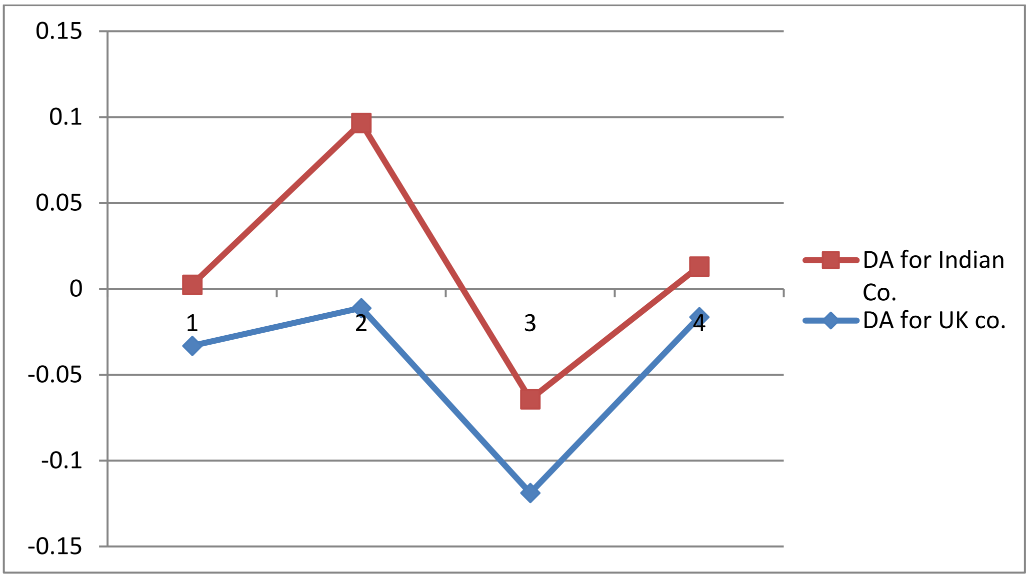
Table -1: Average of DA for sample companies

year	DA Average of UK Co.	DA Average of Indian Co.
2011-12	-0.0331939	0.03567821
2012-13	-0.011091	0.10766856
2013-14	-0.1188843	0.05456503
2014-15	-0.0163227	0.02926036

Sources: self-compiled

From the above table we can clearly see that both the type of sample companies practice earnings management. But the average Discretionary accruals which is taken as proxy for Earnings management is much less for UK companies as compared to Indian companies. Moreover, the averages are negative for the UK companies. This could be more clearly shown with the following chart.

Chart-1



From the above result we can assume that Indian companies are more engaged managing earnings as compared to UK companies. The impact of IFRS can influence the companies to understating the financial statements when it comes to using managerial discretion. But Indian companies use their managerial discretion more aggressively.

V. CONCLUSION

This study investigates the inverse relationship between implementation of IFRS and earnings management practices. We focused on economy where IFRS is mandatory and voluntary. The result of our study supports that there is existence of earnings management practice. As per our analysis the implementation of IFRS is limiting the earnings management which is generated by using managerial discretion. Managing earnings is not equals to fraud, sometimes it may be done in a way that is more legitimate. To define the clear line between the legitimate and illegitimate way of using managerial discretion there is a need of strict rules and regulations. IFRS limits the managerial discretion and possibility for Earnings Management based on accrual manipulation.

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