Effects of IFRS Adoption in Nigeria on Profitability Ratios: Evidence from the Conglomerate Sector

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Abstract

This study examined the effects of IFRS adoption on the profitability of firms in terms of financial statement items using profitability ratios. Data were sourced from financial statements of five companies listed on the conglomerate sector of NSE for a period of four years. The data were analysed using descriptive statistics and OLS Regression from SPSS. It was found out that profitability ratio of firms after IFRS adoption reduced. It is therefore recommended that adequate care should be taken by the users of financial statements in making economic decisions because of the new features in the financial statements prepared under IFRS.

Keywords: International Financial Accounting Standards, Statements of Accounting Standards, Profitability, Profitability Ratios, Conglomerate Sector.

Introduction

International Financial Reporting Standards are globally accepted high quality reporting standards which are believed to reshape companies' external and internal management reporting as most companies adopt it for not only their consolidated accounts but also for internal management use in the parent companies and subsidiaries (Jacob & Madu, 2009).

Several studies have examined the impacts/effects of IFRS adoption in different parts of the world. Most of these studies (Abdul-Baki, Uthman & Sanni 2014, Nengzih, 2015, Yahaya, Yusuf & Dania, 2015, Okpala, 2012, Umoren & Enang, 2015) have focused on FDI, accounting practices, value relevance, financial ratios, equity, profitability rate and tax income etc. but very few have specifically studied the effect on profitability ratios which has created a gap in literature. Also, the results from previous studies have been a mixed one thereby creating a gap that this study intends to fill; hence the motivation of the study to analyze the effect of IFRS adoption on profitability ratios of Nigerian firms and to identify in particular if the adoption has brought about an increase or a decrease in profitability of firms.

The major objective of this study is to identify the statistically significant differences between the pre and post adoption periods of IFRS in Nigerian firms on the profitability ratios of firms using the SAS-based and IFRS-based financial statements of companies listed on Nigerian Stock Exchange with a sample of the Conglomerate sector, and more specifically to test if the adoption actually brings about an increase in profitability ratios as established by previous studies.

The population of the study is the conglomerate sector of Nigeria which comprises a wide range of activities including manufacturing, packaging, farming, sales and resale enterprises. Five companies were selected using the Yaro Yamane's formula of sample selection.

Literature Review

This section reviewed the limited literatures available for this study as very little studies on the impacts of IFRS adoption has focused attention on profitability ratios in particular.

Nigerian Statement of Accounting Standards

Established in 1982, the Nigerian Accounting Standard Board (NASB) was responsible for setting accounting standards in Nigeria with a view to enhancing a high degree of standardization in the preparation of published financial statements. Accounting standards serve as pronouncement made by recognized bodies that provide frameworks and guidelines through which accounting information is prepared and presented to users of information in permitting an informed judgment.

NASB was established as a private sector initiative and became a government agency in 1992 to report to the Federal Minister of Commerce. It was given a legal backing by its inclusion in Section 335(1) of the Companies and Allied Matters Act of 1990 which mandated all companies to prepare financial statements that comply with Statement of Accounting Standards (SAS) as developed and issued by NASB from time to time. NASB Act of 2003 was then enacted, giving the NASB the full autonomy as a legal entity. This Act provided the legal framework under which NASB set accounting standards and had its major function as developing, publishing and updating Statements of Accounting Standards to be adhered to by companies when preparing their financial statements (Umoren & Enang, 2015).

However, in the late 1990s, when a preparation of Reports on the Observance of Standards and Codes (ROSC) was called for by the international community. It was found out that there were compliance gaps between the SAS and actual practice in published financial statements and

therefore, recommendation was made for the creation of a new independent oversight body which was the Financial Reporting Council (later signed into law on July 20, 2011) to monitor and enforce accounting and auditing requirements with respect to general-purpose financial statements.

Nigerian SAS and IFRS

Several differences exist between the Nigerian SAS and IFRS as it is in other countries of the world which has greatly lessened the degree of confidence in financial statements read by international users. SAS was supposedly based on past IAS (formed by ISAC). However, some of the IASs had been reviewed and updated with IASs/IFRSs owing to the growing intricacy of financial reporting requirements but the SASs were not reviewed or updated which called for the differences and has resulted in SASs being regarded as outdated and incomplete as internationally accepted guide to preparing financial statements. Three SAS are seen to still concur with the requirements of IFRSs that had been withdrawn or outdated and about sixteen IFRS do not even have equivalence in IASs/IFRSs. All these led to the approval of the adoption of IFRS in July 2010 by the Nigerian Federal Executive Council (NASB, 2010).

As opposed to SAS, profitability ratios are affected under IFRS as a result of its principle of early revenue recognition (even if contingency is associated with a portion of it) which brings about higher revenues and higher profitability ratios. Also, resulting in higher revenue and profitability ratios is IFRS allowance for development costs capitalization under certain conditions. However, IFRS only allows for the First-In-First-Out (FIFO) method in inventory valuation which could result in lower profitability ratios when an economy with rising costs is considered (Investopedia, 2015)

Application of IFRS

IFRS as a globally accepted high quality financial reporting standards was introduced in the year 1973 by a formation of International Accounting Standard Committee (IAS) which comprised 16 professional bodies from countries all over the world (Garuba & Donwa, 2011). According to Ezeani and Oladele (2012), the body (IASC) was formally recognised in 2001 and was later transformed into International Accounting Standards Board with the responsibility of developing accounting standards and related interpretations known as International Financial Reporting Standards (IFRS).

The adoption of IFRS is seen as a movement towards fair value which should improve the external reporting perception to notify stakeholders of a company's allure to investors, financial analysts, partners in business or employees. As opined by Jermakowicz (2004), the adoption will allow for relevant information in assisting creditors to estimate the company's ability to make future interest payments, managers to steer and control business in terms of maximizing economic value, suppliers to know whether buyers will continue to place orders, employees to know the firm's value generation and distribution process, and shareholders to know the created shareholder value.

Armstrong, Barth, Jagolinzer & Riedl (2007) noted that, it is as a result of the increase in growth of international trade, cross border financial transactions and investment which inevitably requires accounting reports prepared and presented in a way that will make it useful and accepted across various national borders that has brought about the adoption of IFRS by developed and developing countries.

The adoption of IFRS would lessen the irregularity of information, reinforce the communication link between all stakeholders and also reduce the cost of preparing different versions of financial statements in the case of multi-national organisations (Bushman & Smith, Healy & Palepu, 2001). Barth (2007) also identified the following as benefits of the adoption of IFRS as a common body of international standards: it will reduce the cost of preparation and audit of financial information to capital market contributors; in place of several local accounting standards, IFRS will bring about acquaintance with one common set of international accounting standards; it will ease the work of investment analysts by making possible comparability and uniformity in financial statements among companies and countries; also attracting foreign investors and general capital market liberalization.

Established by Iyoha & Faboyede, 2011, the implementation process of IFRS received a noteworthy boost in 2002 when the European Union adopted a regulation 1606/2002 for all public companies in the territory to convert to IFRSs starting from 2005.

IFRS and Firms' Profitability

As it is generally believed that profit (short-run) and wealth (long-run) maximisation are the basic reasons behind organizations' existence, Jensen (2001) opined that in maximising shareholders' wealth, other stakeholders'/financial claimants' e.g. debt and warrant holders' wealth are also maximised. Also posited by Jensen (2001), organisations must have a way of measuring 'better' as against 'worse'; this can be achieved by increasing stockholders' wealth which serves as benchmark for measuring performance. This, argued by several researchers and scholars is the common benefit among several others ascribed to IFRS adoption as a single set of accounting standards in any jurisdiction.

Examining the impact of IFRS adoption on profitability rate and tax income for a sample of Indonesian Listed Companies, using paired samples t-test, Nengzih (2015) found out that the average ratio of companies' profitability increased as a result of the adoption.

Terzi, Oktem & Sen (2013) in a study carried out on Turkey's listed manufacturing companies, found out that financial statements prepared under local GAAP and IFRS showed a level of significant difference as current ratios, liquidity ratios and profitability ratios increased in value as a result of the transition.

Lantto & Sahlstrom (2009) evaluated the economic consequences of IFRS adoption in Finland by calculating ratios from a sample of 91 firms listed on Helsinki Stock Exchange and found out that there is an increase in profitability ratios but a decrease in liquidity ratios and the PE ratio in the period following the adoption of IFRS.

Callao, Jarne, & Lainez (2007) investigated the relationship between financial ratios and accounting figures in Spain for IBEX-35 companies and found out that, total liabilities, long-term liabilities, cash equivalents and shareholders' equity showed that there is statistically significant difference between financial statements prepared under local GAAP and those prepared under IFRS.

In New Zealander companies, Kabir et al. (2010) investigated the effects of IFRS adoption on accounts and earnings' quality; the result showed that total assets, total liabilities and net profit figures were higher in IFRS-based financial statements.

However, according to Ibiamke & Ateboh-Briggs (2014), profitability ratios were found to have decreased as a result of IFRS adoption, though not statistically significant. A study of the effects of IFRS on ratios in Nigeria was carried out using the Gray comparability index, paired sample t

test and Levene F test on a sample of 60 companies listed on the Nigerian Stock Exchange as at the period of transition.

Hypothesis formulation

The purpose of this study is to investigate the impacts of the adoption of IFRS on profitability ratios and more specifically to test whether the adoption has brought about an increase in the profitability of firms with a sample of the conglomerate sector of companies listed on the Nigerian Stock Exchange. A central question was formed which is: how has the adoption of IFRS influenced the profitability of firms in Nigeria? Out of this question came the hypothesis formulated for this study which was coined out of previous studies that have supported the adoption of IFRS recognising that there had been (positive) statistically significant effects of IFRS on profitability ratios (Nengzih, 2015, Terzi et al 2013, Lantto & Sahlstrom 2009, Callao et al 2007 & Kabir et al 2010). So, the study hypothesizes that:

H_1: IFRS adoption brings about an increase in profitability ratios of firms

Theoretical Framework

This study can be related to the theory of value maximization which states that firms majorly exist to maximize profits in the short-run and shareholders' wealth in the long-run (Friedman, 1970). This explains that every of firm's activities tend towards value seeking which happen to encompass profit maximization. The theory explains further that the long run wealth maximization does not signify the maximization of shareholders' wealth alone but also the maximization of other financial claimants like debt and warrant holders. It can therefore be argued that, the essence of the study population is to maximize firm's value of which IFRS adoption is said to increase profitability ratios (Nengzih, 2014, Terzi et al 2013, Lantto

&Sahlstrom 2009, Callao et al 2007 & Kabir et al 2010) hence, the need to test the effect of IFRS on profitability ratios. However, some factors could be responsible for changes in profitability ratios which explain why leverage and firm size were introduced as control variables. This led to the development of the model used for the research, specified below as:

$PR_{I,T}= \beta_0+\beta_1 LEV_{I,T}+\beta_2 SIZ+e$

Methodology

In remaining consistent with previous studies, a cross sectional research design was used to measure the effects of IFRS on profitability ratios of the sampled population due to the fact that data for quoted companies in Nigeria are kept annually and the data needed for this study were collected at a particular point in time over a period of four years (2010-2013). The data set took two forms; accounting figures were first extracted from the financial statements of the sampled companies to compute profitability ratios. The study then adopted descriptive statistics and Ordinary Lease Square (OLS) regression on Statistical Package for the Social Sciences (SPSS) to analyse the profitability ratios obtained using 2010 and 2011 as the pre adoption years and comparing it with 2012 and 2013 used as post adoption years with a total of 20 observations (n =20).

The population of the study was the Conglomerate sector of the Nigerian Stock Exchange and applying Yaro Yamane formula to the population of 9 companies,

$n = N/1 + N (e)^2$

Where n = sample size

N = population of study

e = tolerable error at 5%

Therefore, $n = 9/1 + 9 (0.05)^2$

$n = 9/1 + 9 (0.0025)$

$n = 9/1 + 0.0225$

$n = 9/1.0225$

$n = 8.81$

Approximately 9 firms were got as the sample size but due to unavailability of information and negative figures declared by two of the companies, only five companies (PZ, Chellarams, A. G. Levetis, Transcorp and UAC) were used as the study sample size.

Model specification

The study focused on five measures of profitability ratios; Gross Profit Margin, Net Profit Margin, Profit After Tax to Earnings Before Interest and Taxes, Return on Investment (before tax), and Return on Equity. The composition of these measures is discussed below.

Profitability ratios show the financial health of a firm, and the higher the profitability ratios, the higher the availability of funds. IFRS adoption is believed to improve this ratio since it's of high quality standards. The study predicts that this ratio will increase after IFRS adoption, but the increase may not necessarily be because of IFRS. Hence, leverage and firm size were introduced as control variables.

$PR_{I,T} = \beta_0 + \beta_1 LEV_{I,T} + \beta_2 SIZ + e$

Divided into:

$GPM_{I,T}= \beta_0+\beta_1 LEV_{I,T}+\beta_2 SIZ+e$…… 1

$NPM_{I,T}= \beta_0+\beta_1 LEV_{I,T}+\beta_2 SIZ+e$…… 2

$ROI_{I,T}= \beta_0+\beta_1 LEV_{I,T}+\beta_2 SIZ+e$…….. 3

$ROE_{I,T}= \beta_0+\beta_1 LEV_{I,T}+\beta_2 SIZ+e$……. 4

$PAT/EBIT_{I,T}= \beta_0+\beta_1 LEV_{I,T}+\beta_2 SIZ+e$…… 5

Where:

GPM = gross profit/sales or EBIT/sales

NPM = profit after tax/sales or EBIT (1- T)/sales

ROI (before tax) = EBIT/Net assets or Capital employed

ROE = Profit after tax/Net worth

PAT to EBIT ratio = PAT/EBIT

LEV = total liabilities/ total assets

SIZ = natural log of total assets

e = error term

Data Analysis and Results

This section analysed the data collected from different companies listed under the conglomerate sector of the Nigerian Stock Exchange to test the impact of IFRS adoption on profitability of

firms. Table 1 presents the descriptive statistics of sample variables between periods under study using mean, media and standard deviation while table 2 presents the profitability ratios showing residuals and p-value using OLS regression on SPSS.

Table 1: Descriptive statistics

GAAP (n=20) IFRS (n=20)

	Mean	Media	Standard deviation		Mean	Median	Standard deviation
GPM	0.3176	0.2780	0.1873		0.3220	0.2487	0.2319
NPM	0.1331	0.1130	0.1305		0.0987	0.0660	0.1118
ROI	0.1613	0.1573	0.0500		0.1314	0.1275	0.0416
ROE	0.1401	0.1663	0.0640		0.0928	0.0808	0.0513
PAT/EBIT	0.8534	0.8602	0.3228		0.4714	0.5680	0.2434
SIZE	17.4028	17.5591	0.8935		17.7423	18.0385	0.9314
LEV	0.4967	0.4859	0.1351		0.4975	0.4672	0.1528

Source: SPSS

Table 1 represents descriptive statistics of the variables used in the analyses. Both have been computed separately for firms that reported under the Nigerian SAS and IFRS. From the table, the mean of GPM increased in the post adoption period from 0.3176 to 0.3220; the mean of NPM reduced in the post adoption period from 0.1331 to 0.0987. ROI reduced from 0.1613 to 0.1314. ROE reduced from 0.1401 to 0.0928 while PAT-EBIT also reduced took a downturn from 0.8534 to 0.4714. However, the control variables show an increase in the post adoption years that is, firm size increased from 17.4028 to 17.7423 and leverage increased from 0.4967 to

0.4975. Therefore, it could be said that the change in leverage and firm size could have been the cause of the changes in profitability ratios.

Table 2: Profitability ratios

	Residuals	P-value
GPM: Pre	0.161	0.095
Post	0.291	0.169
NPM: Pre	0.085	0.126
Post	0.050	0.060
ROI: Pre	0.021	0.798
Post	0.009	0.125
ROE: Pre	0.025	0.245
Post	0.019	0.471
PAT/EBIT: Pre	0.507	0.116
Post	0.408	0.393

Table 2 represents analyses for profitability ratios. The variables were further analyzed against control variables, which indicate a reduction except for GPM. GPM increased in the post adoption period from 0.161 to 0.291; NPM reduced from 0.085 to 0.050. ROI reduced from 0.021 to 0.009, ROE went down from 0.025 to 0.019 and PAT -EBIT as at the period of pre adoption was 0.0507 as against 0.0408 in the period of post adoption.

The findings from the analyses indicate a reduction in the profitability ratios after IFRS adoption.As against the prediction of this study and contrary to the findings of Nenegzih, 2012,

Terzi et al 2013, Lantto & Sahlstrom 2009, Callao et al 2007 & Kabir et al 2010) the study found out that there is no increase in profitability ratios in the period after the adoption of IFRS except for GPM which showed a slight increase. Theresulthowever agrees with the findings of Ibiamke & Ateboh-Briggs (2014) which reported that, although not statistically significant, profitability ratios were found to have decreased as a result of IFRS adoption.**Discussion of Findings**

The study examined the effects of IFRS adoption on profitability ratios in Nigeria. Using descriptive statistics and Ordinary Lease Square (OLS) regression on Statistical Package for the Social Sciences (SPSS) to analyse the profitability ratios obtained with years 2010 and 2011 as the pre adoption years and comparing it with 2012 and 2013 as post adoption years, the study found that IFRS adoption has led to a decrease in profitability ratios. The study also found that leverage ratios have increased during the transition and so also firm size. This finding led to the conclusion that though several researchers have reported increase in profitability of firms as a result of IFRS adoption, the effect is a mixed one as this study shows a contradictory view which agrees with the view of Ibiamke and Ateboh-Briggs (2014).

Policy Implications

Going by the findings of this study and in agreement with the findings of Ibiamke & Ateboh-Briggs (2014), a reduction in the profitability of firms will have the following (but not limited to) implications on the economy:

1. A reduction in profitability will adversely affect the corporate social responsibilities of firms as this is usually dependent on the level of profit made. When firms make more profits, a part of the profits goes into the development of the community in which the firms operate but a

lower profit will make the firms cut down on their responsibility to their immediate environments

2. Employees of firms with lower profits will also be affected as a reduction in the profit of the firms may bring about a reduction in the remunerations of workers as the firms look out for a way in which costs can be reduced. Also, the firms may decide to lay off some workers which may bring about an increase in unemployment which is one of the macroeconomic variables affecting the nation

3. A lower profit also implies lower taxation as taxes of corporations are based of their level of profitability. When companies make lower profits, it means the revenue generated by the government in form of taxes also reduces. A reduction in government revenue will bring about inadequate infrastructural provision to the economy at large.

4. A declaration of lower profit will affect the image of the company adversely which will bring about loss of interest in such firms. That is, people prefer to invest in more profitable businesses which will give them higher returns on their investment but a lower profit connotes that shareholders/stakeholders will be receiving a lower returns on their investments/commitments.

5. Reinvestment of funds will also be affected as more profit implies more money to be reinvested which should bring about expansion but a lower profit implies lesser money to be reinvested.

6. Also, reinvestment and expansion should bring about more employment opportunities in the society but when expansion is shortened, employment opportunities are limited

The aforementioned implications seem to be negative however; a positive implication of a lower profit figure is that, it could have been that firms had been declaring arbitrary profits before now that is, the firms may have been declaring a profit that is higher than what it really was but a reduction in their profit now shows conservatism, that is, the firms are now more conservative in their profit declaration which happens to be one of the principles of accounting which states that firms should select or recognise a transaction that is least likely to overstate assets and income or one that will likely result in a lower profit when choosing between or among alternatives.

Policy Recommendations

To avoid the aforementioned effects on the economy which may be brought about by a reduction in the level of profitability of firms in Nigeria, care should be taken when preparing financial statements in compliance with the new reporting standard (IFRS) as it may not yet be fully understood thereby causing the preparers of financial statements to make mistakes in the interpretation of terms which could bring about a wrong computation thereby resulting into wrong presentation of firms' true picture.

Caution should be taken by users of information contained in financial statements when taking economic decisions because of the new features contained in the financial statements prepared under IFRS so that the information will not be misinterpreted.

Also, analysts are therefore encouraged to adopt a cautious approach when examining profitability ratios during the transition to IFRS in Nigeria. Comparing ratios based on IFRS figures with those based on SAS is not fully appropriate. Users of financial statements need to distinguish reported performance changes caused by the transition to IFRS from those caused by changes in the business as increase may not necessarily be caused by the change in reporting

standards but also by other factors which may include leverage and firm size. One possible solution may be to recalculate previous ratios using IFRS retroactive information presented in the year of the transition. However, this may be a costly exercise which is still subject to limitations such as exemptions and exceptions allowed by IFRS 1. Analysts need to be aware of the main features of IFRS that differ from SAS.

Users of financial statements should be mindful of the new feature – comprehensive income – for which two ratios are suggested: the ROA and ROE. These ratios are adapted from the regular ROA/ROE but with the comprehensive income at the numerator. The comprehensive income incorporates unrealized gains and losses that bypass the profit of the income statement. A difference between the regular and the comprehensive versions of ROA/ROE should prompt further investigation of the underlying causes (Blanchette, Racicot & Girard, 2011).

However, following the concept of conservatism, it is recommended that firms should adopt IFRS as this will help them in being more conservative in their profit declaration and they will not be paying taxes that are more than what they should actually pay, also other payments such as shares premium, cost of social responsibilities etc. which are paid according to the level of profit declared will not be more than it really should be.

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