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Accounting Conservatism and Tax Influence after IFRS Adoption in Nigeria

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Abstract

The study tends to examine the link between taxation motive and accounting conservatism after IFRS adoption in Nigeria. Unconditional conservatism was used as proxy to conservatism, Marginal tax rate was used as a proxy for tax burden, while controlling for Leverage (LV), Profitability (PROA) and Firm Size (FS). The result reveal MTR to be positive and significant which is similar to most studies (Boyoung & Kooyul, 2007; Kelley, 2005) conducted before IFRS adoption in Nigeria. This result suggest that IFRS (flexibility in implementation) give managers more incentives to make accounting information seem more credible by using conservative accounting techniques, thus, boosting conservatism. The study recommends that the Financial Reporting Council of Nigeria together with its subsidiary agencies should ensure proper implementation of IFRS by especially large corporation.
Keywords: Conservatism, Tax Influence, IFRS Adoption, Nigeria.

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Introduction

The quality of financial reporting is indispensable to the need of users who require them for investment and other decision making purposes (Fashina & Adegbite, 2014). This makes convergence to International Financial reporting standards so rapid that over 100 countries have already moved to adopt the standards for financial reporting preparation and presentation purposes. Hence, the question of whether the adoption of IFRS fosters overseas activities is of special interest, especially in the light of the EU's massive adoption by listed companies. In this vein and in the Nigerian context, the Nigerian Accounting Standards Board (NASB) was responsible for developing and issuing standards known as Statements of Accounting Standards (SAS) and in the new dispensation, the body was renamed Financial Reporting Council (FRC) of Nigeria as the regulatory body overseeing the adoption and implementation IFRS (Kenneth, 2012). Adoption of such standards is seen among others, to help IFRS-users from other countries to understand financial information, thus reducing information asymmetries between users of financial statements in different countries.

Another importance or significance of IFRS is its flexibility towards making various accounting choices. Example of which include selecting between fair value accounting or the historical cost accounting (conservatism), thus, making it more reasonable for shareholders to predict if managers will make choices that will give them more room to manage earnings. If this is the case, then, from managers' point of view, they have an incentive to make their financial statement seem credible by choosing conservative accounting methods and, thus, enhance conservatism. As LaFond and Watts (2008) puts, incorporating more fair value into financial statements, like increase in growth options, may generate an increase in information asymmetry and accounting conservatism. One more reason that makes accounting conservatism seem to increase after mandatory IFRS adoption is the fact that investors expect accounting numbers to be less verifiable. The credibility which is the most important characteristics of accounting playing as a role of information source comparing with other information sources, such as press or media, decreases. For this, investors will require higher rate of return, improving cost of equity. Moreover, information asymmetry will increase if investors anticipate more earnings management.

However, there are concerns over the years as to whether conservatism will be used for its intended purpose. Moonitz (1951) suggest that "Historically this [conservative] bias was undoubtedly useful in neutralizing the tendency of a businessman to overstate his profits and his net worth in order to make a better impression with creditors and absentee owners. At the present time, however, with income tax rates at high levels, the incentive is probably in the other direction; so that the traditional rules of conservatism may actually be dangerous. Recently, [labor) unions have made much of the level of corporate earnings in collective bargaining negotiations, adding more incentive for management to choose the smaller rather than the larger figure." There are warnings that the existence of high corporate taxes and influential labor unions might reduce firm's inducement to overstate. This unwillingness does not indicate that the existence of high corporate taxes and great labor unions completely eradicate the firm's incentive to prejudice upward but does warn the accounting academic world that combating overstatement is not the only reason why conservatism is beneficial.

Companies are therefore being suspicious of choosing conservatism in order to avoid tax. The tax aggravated conservatism is especially interesting in view of recently increasing doubts that many large U.S. corporations have smaller tax burdens than their real economic earnings would imply (U.S. Treasury, 1999; Desai, 2002). It requires an assumption that book income is closely attached to taxable income. Without conformity between book and taxable income, a firm's best tax strategy would be to decrease taxable income without decreasing book income. The research will therefore contribute to the literature by investigating whether firms' commitment to accounting conservatism relates to tax avoidance after IFRS adoption. The main aim of the study is to investigate whether conservatism in financial reporting is tax driven. Specifically, the study tends to examine the impact of Marginal Tax Rate on Unconditional Conservatism (UC) after IFRS adoption in Nigeria.

Literature Review and Hypothesis Development

A number of studies have over the years looked into the relationship between Conservatism and other variables like Investment efficiency (Juan, Beatriz & Fernando, 2016; Paul, Mingi Toa, 2010, Naveed, Zhang & Zou (2016); Jungeun & Won-wook, 2016; Anwer & Scott, 2011), ownership structure (Xiadong, Xia & Nina, 2012) and acquisition (Francis & Martin, 2010). However, little empirical evidence (e.g Samira & Domunique, 2007 – French) investigates the change in conservatism after IFRS adoption. Most of this literature shows that either there are no changes (Fullana & Toscano, 2016) or there is an increase Callao et al., 2010) in the balance-sheet conservatism after the application of IFRS. Therefore, in order to fill up this literature gap, this study will explore accounting conservatism under IFRS adoption. As regards tax motivated conservatism, there are empirical evidences (Kim & Bae, 2006; Kelley, 2005; Boyoung & kooyul, 2007) investigating either relationship or influence, with little attention paid to what the relationship or influence will be after IFRS adoption. The following hypothesis is therefore developed.

H1 *The higher the level of tax motivated conservatism, the higher the marginal tax rate after IFRS adoption*

The Concept of Conservatism

Ball, Kothari and Nikolaev (2013) claimed that there is no single definition of the concept of conservatism, and depending on the author, it is related alternatively to the income statement or the balance sheet of companies. Conservatism is considered a traditional measure of profits where losses are recorded immediately while gains only after being realized. In long term consequences of accounting conservatism will be an understatement of net asset. As interpreted by Basu (1997), conservatism is seen as accountants' tendency to require a higher degree of verification to recognize good news as gains than to recognize bad news as losses. In other words, Watts (2003); Ball and Shivakumar (2005); Francis and Martin (2010) and Bushman, Piotroski, and Smith (2007) view accounting conservatism as a means of combating optimism or the insider's tendency to overstate. It is being regarded as a mechanism for monitoring manager's incentives to over- or –under invest.

Accounting conservatism can be classified into two as follows;
Conditional Conservatism (CC): the ex post or news dependant conservatism refers to the extent of conservatism in which accounting measurement depends on the characteristics of the event being measured. Examples usually have a lower of cost or market feature in accounting for inventory and asset impairments (Frank, Chandra, Haresh & Raghu, 2009).

Unconditional Conservatism (UC): the ex-ante or news independent conservatism, is an accounting measurement bias that is unaltered by the features of the event that is measured. An ordinary quoted example of unconditional conservatism is the instant writing off of all R&D irrespective of the likelihood of success of the underlying R&D projects (Frank, Chandra, Haresh & Raghu, 2009).

For the purpose of this study, UC will be used as a proxy for accounting conservatism. This is in line with Boyoung and Kooyul (2007) who find that unconditional conservatism measure is more appropriate to test tax motivated conservatism.

Research Methodology

Population and Sample

The population of the study comprise of companies listed on the NSE from which a desirable sample was drawn for a period of 12 years (2007 – 2018). The criteria used for sample selection was that, all companies that reports loss were dropped. Descriptive statistics, correlation and regression analysis were used in analyzing the data involved.

Variables and Their Measurement

The Dependent Variable, Unconditional Conservatism (UC) is measured following Givoly and Hayn (2000)

$$\mathrm{UC\_ACC} = \left(-\frac{1}{3}\right) \times \sum_{\tau=0}^{2} \frac{\mathrm{PTI}t-\tau+\mathrm{DEPt}-\tau-\mathrm{CFOt}-\tau}{\mathrm{TA}t-\tau}$$

Where PTI, DEP, and CFO mean pre-tax income, depreciation and operating cash flows respectively. *TA* is total assets at the beginning of year.

The independent Variable, Marginal Tax Rate (MTR) is measured following Graham (1996a), whereas the control variables include; Leverage-LV measured as Debt/Total Assets, Profitability-PROA measured as Profit before Tax /Total Assets and Firm Size-FS measured as Ln(Total Assets).

Model

The study assesses the impact of Tax burden on conservatism. It does that by regressing the UC measures on marginal tax rate. Thus, the following function is obtainable;
UC = F (MTR+LV+PROA+F.S)

$UC_{it} = \beta_0 + \beta_1 MTR_{it} + \beta_2 LV_{it} + \beta_3 PROA_{it} + \beta_4 FS_{it} + \varepsilon_{it}$

Where;
UC = Unconditional Conservatism
MTR = Marginal Tax Rate
LV = Leverage
PROA = Profitability
FS = Firm Size
$\varepsilon_{it} =$ Error Term

Results and Analysis

Table 1: Descriptive Statistics

	Mean	**StdDev**	**Min**	**Max**
UC	0.003	1.467	0.001	3.393
MTR	0.138	0.085	0.001	0.213
LV	0.825	2.614	0.002	3.305
PROA	0.059	0.375	0.012	0.258

The descriptive statistics results above shows a moderate level of dispersion for conservatism, with mean value of 0.003, StdDev of 1.467 and maximum value of 3.393. The values for MTR are shown to be low all through, much alike with the control variable PROA. One of the control variables FS is said to carry the highest values. The result suggests that the sampled firms use a significant level of debt which results to high interest expenses, hence, leading the firms to maintain low profitability.

Table 2: Correlation Matrix

	UC	MTR	LV	PROA
MTR	0.520*	1.000		
LV	-0.093*	0.637*	1.000	
PROA	-0.110*	-0.195*	0.058*	1.000
FS	0.415	-0.070*	0.036**	0.070**

The table above shows the correlation among Conservatism (UC), Marginal Tax Rate (MTR) and the control variables selected. UC and MTR have positive and significant relationship, depicting that firms practicing conservatism are said to be having high tax burden. On the contrary, both Leverage (LV) and Profitability (PROA) show negative and significant relationship to Conservatism.

Table 3: OLS Regression

	Coefficients	T-stat	Sig
Intercept	10.933	8.667	0.000
MTR	0.229	11.413	0.000
LV	0.116	3.469	0.000
PROA	0.175	6.583	0.000
FS	0.012	1.367	0.057

The coefficient of the MTR, shows a positive value, with t-stat of 11.413 significant at 1%. This suggest that the stronger the conservatism, the higher the marginal tax rate. This result supports hypothesis of the study which reads as thus; *the higher the level of tax motivated conservatism, the higher the marginal tax rate after IFRS adoption. This is* in line with Boyoung and Kooyul (2007) who found that conservatism level is positively related with a firm's tax burden. Also in consistent with Kelley (2005). However, the findings contradict Kim and Bae (2006) whose attempt shows insignificant relationship.

Leverage (Lv) also shows positive and significant effect conservatism. Same results proved by Watts (2003); Joo (2009); Rahimah (2011) and Sulaieman and Anifowose (2014). When firms use more of debt to equity to finance their operations, profitability is said to decrease due to payment of high interest expenses, hence leading to payment of lower tax. Similarly, Profitability (PROA) reveals a significant positive impact on conservatism, holding on to the claim that conservatism is practiced much by more profitable firms. Same result was revealed by Ahmed, Billings, Morton, and Stanford-Harris (2002); Boyoung and Kooyul (2007) while contradicting Sulaieman and Anifowose (2014).

In the same vein, Firm Size (FZ) shows a positive and significant impact on conservatism. This is in line with our expectation since larger firms are said to be more conservative. The finding is same with Boyoung and Kooyul (2007) while contradicting Sulaieman and Anifowose (2014), Joo (2009) and Rahimah (2011).

Limitation and Frontier for Further Studies

The main limitation of this study is that, it considers only one measure of unconditional conservatism (the accrual-based measure), for which the result might be different should other methods (book-to-market measure or reserve-based measure) be used. Other researchers can explore more by looking at how strong is the conservatism level after IFRS adoption in Nigeria.

Conclusions

The study attempts to explore the link between taxation motive and accounting conservatism after IFRS adoption in Nigeria. As Watts (2003a) puts, "most firms make efforts to achieve tax minimization through tax agents. Accounting conservatism is one way to implement tax minimization because it decreases net income of firms, reduces taxable income and corporate taxes. As long as a firm is profitable and has taxable income, a firm has an incentive to defer income to reduce the present value of taxes". The paper chose unconditional conservatism to proxy conservatism, Marginal tax rate to proxy tax motive together with some control variables. The result was similar to most studies (Boyoung & Kooyul, 2007; Kelley, 2005) conducted before IFRS adoption in Nigeria. The possible reason as to why accounting conservatism stays after IFRS adoption in Nigeria might be due to investor's expectations that accounting numbers will be less verifiable, hence reducing the credibility of accounting information. Moreover**,** IFRS are principle-based standards with little implementation guidance. The flexibility in their implementation gives firms the ability to choose between different accounting methods, estimates, etc., allowing them more space to manage earnings. This may then suggest that managers have incentives to make accounting information seem more credible by using conservative accounting techniques, thus, boosting conservatism. The study recommends that the Financial Reporting Council of Nigeria together with its subsidiary agencies should ensure proper implementation of IFRS by especially large corporation.

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