

Effect of the adoption of International Financial Reporting Standards on the relationship between working capital management and profitability

On going research

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Research area: Financial Management and
Financial Reporting Standards

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ABSTRACT

- This study examines the potential effects of and issues arising from the adoption of the International Financial Reporting Standards (IFRSs) on the relationship between working capital management (WCM) and profitability.
- A sample of 36 companies listed in the Nairobi Stock Exchange (NSE) for the periods before and after adoption of the IFRSs (i.e., 1994 to 1998; 1999 to 2003 and 2004 to 2008) will be used.

Abstract cont'd

- This data will comprise of the various measures of WCM (as measured by the average collection period, the inventory conversion period and the average payment period), profitability (as measured by the gross operating profit ratio), control variables (such as the cash conversion cycle, current ratio, company size, sales growth, leverage and age) and indicator variables (that is, industry and auditor dummies).

Introduction

- WCM, which deals with the management of current assets and current liabilities, directly affects the liquidity and profitability of the company (Deloof, 2003; Eljelly, 2004; Raheman and Nasri, 2007; Appuhami, 2008; Christopher and Kamalavalli, 2009; Dash and Ravipati, 2009).
- The adoption of IFRSs presents an opportunity to firms in transforming their finance functions and creating more value for their companies by creating operational efficiencies (Accenture, 2009). Various studies have found out that accruals management has a negative relation to a firm's performance (Sloan, 1996; Chan et. al., 2004; Chan et. al., 2006; Huang et. al., 2008b).

Background to the study

- There is a growing number of studies that question the quality and relevance of International Financial Reporting Standards (IFRSs) to developing and emerging economies (see World Bank, 2001).
- The adoption of IFRSs has largely been supported by the fact that IFRSs are associated with greater accounting quality (Barth et.al. 2006; Barth et. al., 2008).

Problem Statement

- The study will be aimed at examining the issues associated with the adoption of the IFRSs in relation to WCM and profitability.
- This study will further seek to examine the relationship between working capital management and profitability for listed companies on the NSE and the effect of the adoption of the IFRSs.
- The study seeks to find out whether the adoption of IFRSs presents an opportunity to firms in transforming their finance functions and creating more value for their companies by creating operational efficiencies as postulated by Accenture (2009).

Objectives of the study

1. To examine the issues associated with the adoption of the IFRSs in relation to the company's WCM and profitability.
2. To establish the relationship between WCM components and Profitability.
3. To establish the effect of the adoption of the IFRSs on the relationship between working capital management and corporate profitability.

Research questions

- To achieve the above objectives, the following research questions will be developed and tested against each research objective:
 1. What are the issues arising from the adoption of IFRSs in relation to WCM and profitability?
 2. What is the relationship between WCM and profitability?
 3. What is the effect of the adoption of IFRSs on the relationship between WCM and corporate profitability?

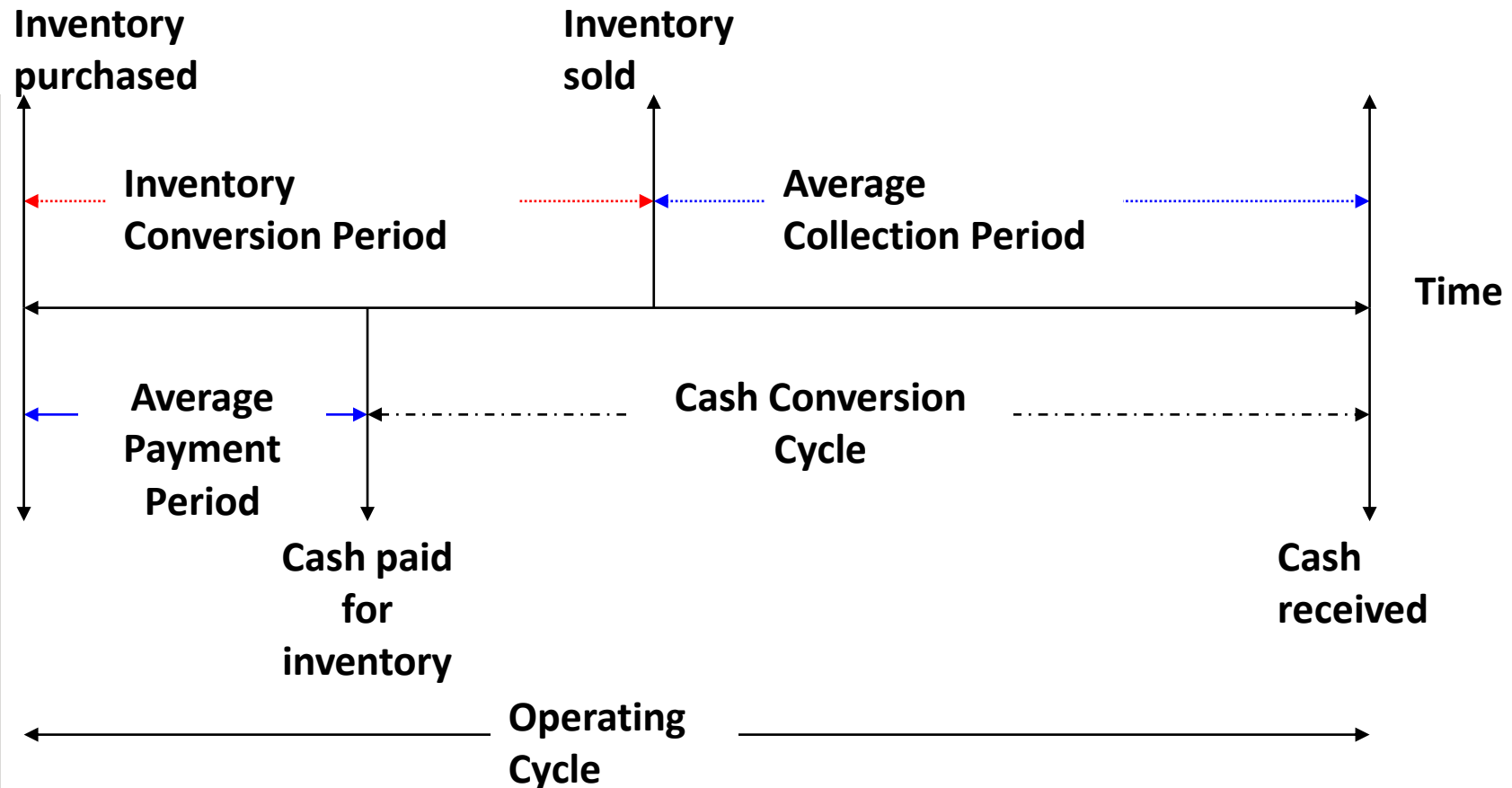
Extant Research

- Deloof (2003) defines working capital management (WCM) as the cash conversion cycle (see also Shin and Soenen, 1998; Raheman and Nasr, 2007).
- Profitability is the rate of return on company's investment (Deloof, 2003). An unwarranted high investment in current assets would reduce this rate of return (Vishnani, 2007).
- According to Lazaridis and Tryfonidis (2006), there seems to be a strong negative relation between the cash conversion cycle of a firm and its profitability (see also Shin and Soenen, 1998; Deloof, 2003; Padachi, 2006; Raheman and Nasr, 2007).

Extant research cont'd

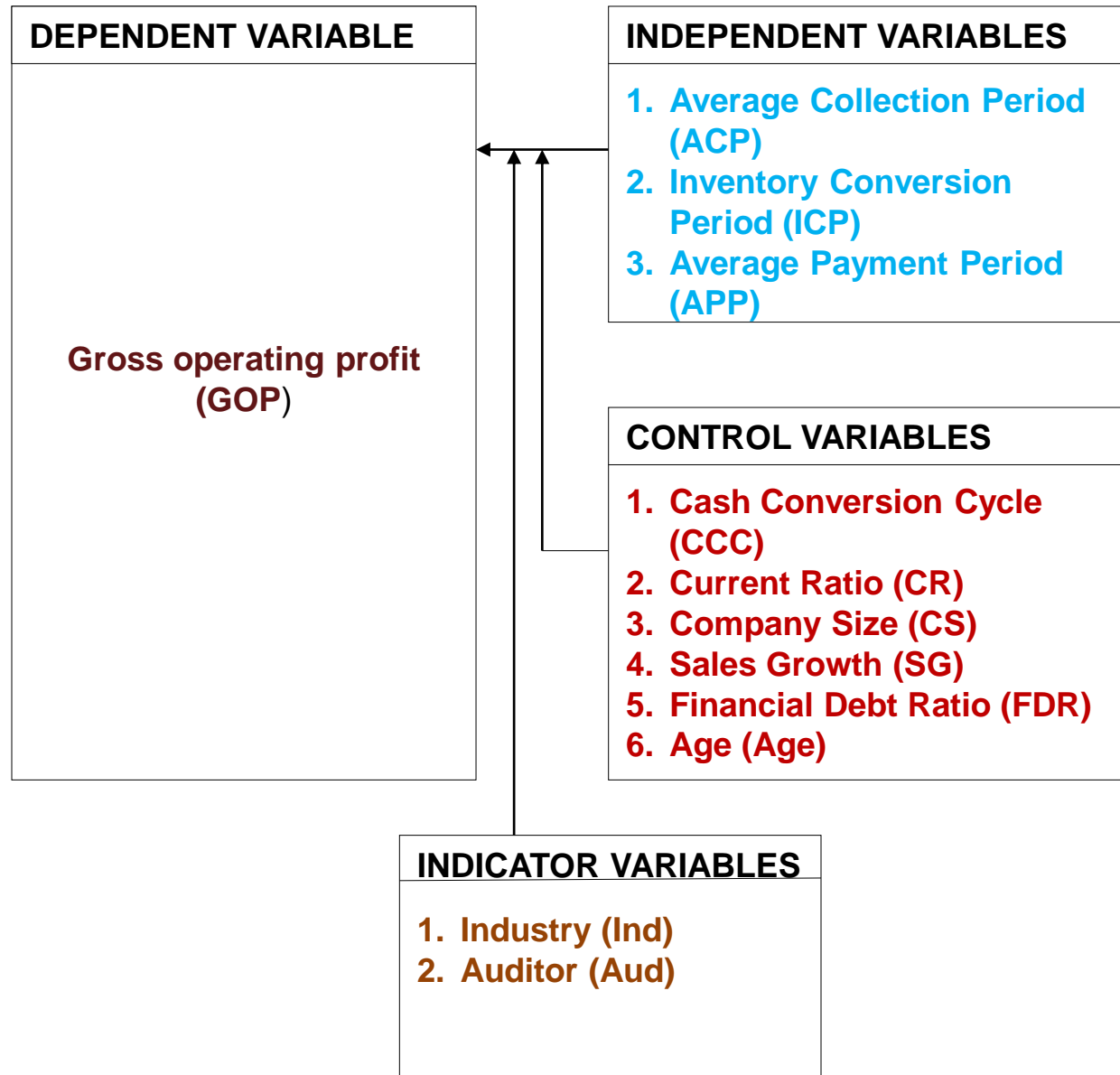
- The adoption of IFRSs presents an opportunity to firms in transforming their finance functions and creating more value for their companies by creating operational efficiencies (Accenture, 2009).
- Sloan (1996) indicates that the extent to which income reported reflects the firm's economic fundamentals decreases in the magnitude of the accrual component of income and increases in the magnitude of cash flow component of income (see also Huang et. al., 2008b).
- Huang et. al. (2008b) observes that there is substantial evidence in support of managerial manipulation of earnings by adopting aggressive accounting choices (see also Burns and Kedia, 2008 ; Huang et. al. 2008a; Kao et. al., 2008).

Operating and the cash conversion cycle



Source: Ross et. al. (2003, p. 167)

Conceptual framework



Research methodology

- This study will be a cross-sectional study using longitudinal data to establish a causal relationship between the variables under study (i.e. IFRSs, WCM components and corporate profitability).
- Examining panel data for this study requires a cross sectional analysis to find out the relationships existent amongst the variables under study over a given time period (Huang et. al. 2008b).
- Since the study also seeks to find out the effect of the adoption of IFRSs on the key variables under study (i.e., WCM and profitability), this will require a test for the strength of the models developed, both during the pre and post adoption periods.

Data set and sample

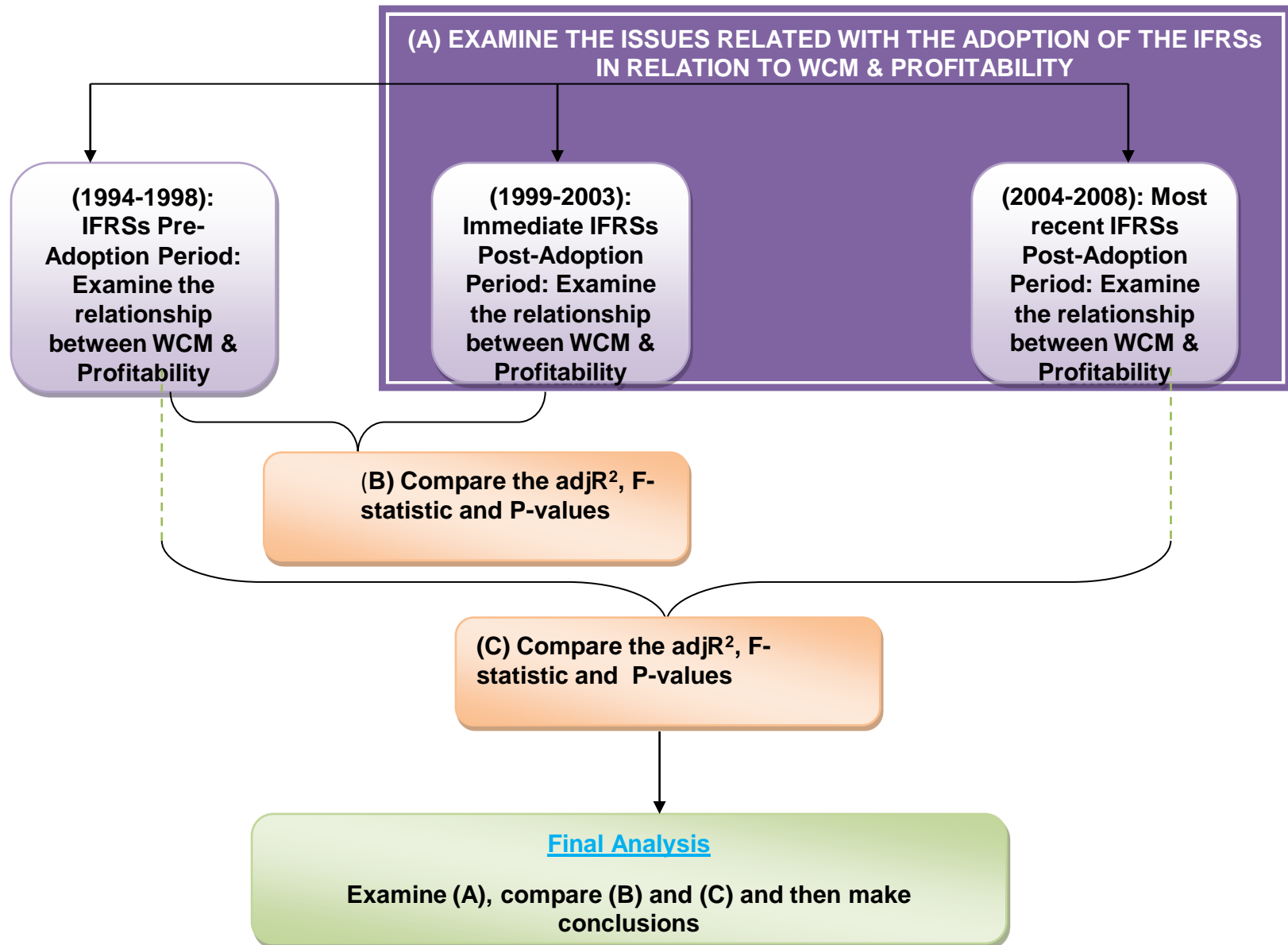
- The data used in this study will be acquired from the Kenyan Capital Market's Authority library, the internet and web sites of the Nairobi Stock Exchange and firms under study. Data will be obtained from the financial statements for a selected sample of Kenyan firms listed on Nairobi Stock Exchange (NSE) for a period of fifteen years (1994 to 1998; 1999 to 2003 and 2004 to 2008)
- For the purpose of this research, certain industries will be omitted due to their type of activity.
- In obtaining this data, this study will follow the classification of NSE from which banking and financial institutions, insurance, some commercial and service firms and some companies listed under industrial and allied segment will be omitted.

Sample representation

Segment	Number of Companies Listed*	Number included in the sample	Percentage of companies included
Agricultural	4	4	100%
Commercial and services	12	9	75%
Industrial and allied	18	15	83%
Alternative Investment	8	8	100%
Market Segment			
Total	42	36	86%

Years	Estimated number of firm year observations	Percentage of firm year observations
1994 – 1998	180	33.3%
1999 - 2003	180	33.3%
2004 - 2008	180	33.4%
Total	540	100%

Research conceptualization



Data collection and analysis

- The data will be collected from listed firms in the Nairobi Stock Exchange Market.
- The collected data will be analyzed and interpreted with the help of different point in time financial ratio estimates, the OLS regression using Minitab software, correlation analysis (both Pearson and Spearman's for comparison) and the *F*-test through the Analysis of Variance (ANOVA) at 95% confidence level.
- To examine the issues associated with the adoption of IFRSs in relation to company's WCM and profitability, a structured interview will be developed and applied to all companies under survey. The results will be analyzed in form of tables, graphs and histograms.

Variables

Independent variables

- The average collection period (ACP) will be used as proxy for the collection policy as an independent variable
$$ACP = \frac{A/R}{Sales} \times 365$$

- Inventory conversion period (ICP) will be used as proxy for the inventory policy is also an independent variable.

$$ICP = \frac{Inventory}{COGS} \times 365$$

- Average payment period (APP) will be used as proxy for the Payment Policy is also an independent variable

$$APP = \frac{A/P}{Purchases} \times 365$$

- (see Deloof and Jegers, 1996; Soenen, 1998; Deloof, 2003; Raheman and Nasri, 2007).

Control variables

- The cash conversion cycle (CCC)

$$CCC = ACP + ICP - APP$$

- Current ratio (CR) $CR = \frac{CurrentAssets}{CurrentLiabilities}$

- Sales growth (SG) $SG = \frac{S_1 - S_0}{S_0}$

- Leverage $FDR = \frac{STL + LTL}{TA}$

- Age $Age = \ln Years$

- (See Emery, 1984; Kamath, 1989; Shin and Soenen (1998); Deloof, 2003; Howorth, and Westhead, 2003; Myers, 2003; Kieschnic et. al., 2006; Vishnani, 2007; Huang et. al., 2008b).

Indicator variables

- In order to control for the possibility that auditors could influence the use of accrual management, an indicator will be used to reveal the presence of the Big Four auditors where 1 will be used to represent the Big Four while 0 will represent any other auditor (see Davidson et. al., 2006; Huang et. al., 2008b).
- The industry will be defined as 1 for agricultural companies, 0 otherwise; 1 for commercial and service companies, 0 otherwise; 1 for industrial and allied companies, 0 otherwise and 1 for alternative investment market segment, 0 otherwise (see Hawawini, et. al., 1986; Shin and Soenen, 1998; Lazaridis and Tryfonidis, 2006)

Dependent variable

- Consistent with Deloof (2003) and Lazaridis and Tryfonidis (2006), the gross operating profit ratio, (GOP) which is a measure of Profitability of the firm will be used as the dependent variable

$$GOP = \frac{Sales - COGS}{TA - FA}$$

- The reason for using this variable is because the study aims to associate the company's operating 'success' or 'failure' with an operating ratio and relate this variable with other operating variables (i.e. cash conversion cycle).

Regression model specifications

- The OLS to used will be as follows:

$$GOP_{it} = \alpha_0 + \alpha_1 ACP_{it} + \alpha_2 ICP_{it} + \alpha_3 APP_{it} + \alpha_4 CCC_{it} + \alpha_5 CR_{it} + \alpha_6 CS_{it} \\ + \alpha_7 SG_{it} + \alpha_8 FDR_{it} + \alpha_9 Age_{it} + \alpha_{10} Ind_{it} + \alpha_{11} Aud_{it} + \varepsilon_i$$

- Four regression models will be run.

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Thank you