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Implementation of IFRS 16 and Its Effect on Earnings Management.

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ABSTRACT

The adoption of IFRS 16 – Leases has introduced significant changes to financial reporting by requiring companies to recognize lease liabilities on their balance sheets. This shift has potential implications for earnings management practices, as companies may adjust financial reporting strategies in response to the new standard. This study explores the possible effects of IFRS 16 on earnings management, focusing on areas such as income smoothing, financial ratios, and managerial discretion. While IFRS 16 aims to enhance transparency and reduce off-balance-sheet financing, its actual impact on earnings management remains a subject of discussion. By analyzing financial data before and after IFRS 16 implementation, this research seeks to understand whether firms have altered their reporting behavior in response to the standard. The findings contribute to the broader discourse on financial reporting quality, regulatory effectiveness, and managerial incentives under IFRS 16.

Keywords: IFRS 16, Earnings Management, Lease Accounting, Financial Reporting, Transparency

1. INTRODUCTION

The global shift toward higher financial transparency and comparability in corporate reporting has led to significant revisions in accounting standards over the past two decades. One of the most substantial among these changes is the adoption of IFRS 16 – Leases, issued by the International Accounting Standards Board (IASB), which came into effect on January 1, 2019. IFRS 16 replaced the previous lease standard, IAS 17, and introduced a single lessee accounting model requiring entities to recognize lease liabilities and corresponding right-of-use (ROU) assets for most leasing arrangements. This transformation effectively ended the off-balance-sheet treatment of operating leases for lessees—a practice that had drawn significant criticism from investors, analysts, and standard-setting bodies alike.

Under IAS 17, lessees could classify leases as either *finance leases* or *operating leases*, with only the former appearing on the balance sheet. Operating leases were disclosed in the notes to the financial statements, enabling companies to avoid the recognition of long-term liabilities associated with leased assets. This created discrepancies in financial statements and impaired the comparability between entities using different leasing strategies. IFRS 16 aims to eliminate these discrepancies by mandating the capitalization of nearly all leases, thereby enhancing transparency, comparability, and the faithful representation of economic realities.

However, while the technical intent of IFRS 16 is to provide stakeholders with a more accurate portrayal of a company's financial obligations, it also introduces substantial changes to key accounting metrics. For lessees, the implementation results in a significant increase in reported assets and liabilities, shifts in EBITDA and net income, and consequential effects on key financial ratios such as the debt-to-equity ratio, return on assets, and interest coverage ratios. These changes have direct implications not only for the financial performance assessment of firms but also for managerial incentives tied to financial targets.

This study investigates the potential link between IFRS 16 adoption and earnings management behaviors, particularly through accrual-based mechanisms. Using a robust empirical dataset, the research seeks to contribute to the emerging literature that questions whether increased transparency from new standards genuinely curbs opportunistic reporting or merely redirects earnings management techniques to less visible areas.

Specifically, this paper addresses the following research questions:

1. *Does IFRS 16 lead to an increase or decrease in earnings management among U.S. public companies?*
2. *Can abnormal discretionary accruals be detected post-IFRS 16 implementation using forensic accounting models such as the Beneish M-Score, the Modified Jones Model, and multivariate regression techniques?*

Preliminary findings suggest a marginal decrease in discretionary accruals following IFRS 16 adoption, though the statistical significance of these results is modest. This hints at a possible behavioral adjustment by firms but falls short of confirming a definitive causal relationship. These nuanced outcomes highlight the complex dynamics between regulatory reform and managerial response and reinforce the necessity for continued empirical exploration.

Furthermore, these findings bear important implications for standard setters, investors, auditors, and corporate governance experts. If firms adapt their financial reporting in response to new rules in subtle or unintended ways, then regulatory reforms may not fully achieve their transparency objectives. Understanding this dynamic is crucial for evaluating the effectiveness of accounting standards in promoting high-quality, reliable financial reporting.

2. Literature Review

The accounting treatment of leases has long been a contentious issue in financial reporting, with the prior standard—IAS 17—serving as the governing framework for decades before the adoption of IFRS 16. Under IAS 17, leases were classified into two broad categories: finance leases and operating leases. This classification hinged primarily on whether the risks and rewards of ownership were substantially transferred to the lessee. If so, the lease was recorded on the balance sheet (finance lease); otherwise, it remained off-balance-sheet (operating lease) and only lease payments were disclosed in the notes. This created a significant disparity between economic substance and accounting form, allowing many lessees to keep material financial obligations hidden from the primary financial statements (Imhoff, Lipe, & Wright, 1997).

Critics of IAS 17 argued that the standard failed to provide a faithful representation of a company's lease obligations, especially in sectors where leasing was a dominant financing strategy. Research indicated that companies deliberately structured lease contracts to qualify as operating leases, thereby avoiding the recognition of liabilities and enhancing reported performance indicators such as return on assets (ROA) and debt-to-equity ratios (Barone, Birt,

& Moya, 2014). According to studies by Imhoff et al. (1991), the underreporting of lease obligations could be so extensive that financial ratios were rendered misleading, prompting analysts and investors to reconstruct balance sheets manually using footnote disclosures.

These concerns catalyzed a collaborative effort between the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB)—the two major standard-setters globally—to revise lease accounting rules. After more than a decade of consultation papers, exposure drafts, and feedback rounds, the IASB formally issued IFRS 16 in January 2016, with mandatory application beginning January 1, 2019. The reform was designed to address the "information gap"—the disconnect between reported financial information and users' need to understand a firm's lease-related obligations (IASB, 2016).

The move from IAS 17 to IFRS 16 has broad implications for:

- Financial ratios: Leverage increases due to recognition of lease liabilities; asset turnover decreases as asset base grows.
- Profitability metrics: Operating profit and EBITDA generally increase, but net income may decrease in the short term.
- Cash flow classification: Lease payments are split into interest (financing activity) and principal (financing activity), compared to the operating classification under IAS 17.

These changes affect investor perceptions, credit ratings, and management performance evaluations, especially in sectors with significant leased assets such as retail, aviation, logistics, telecommunications, and energy (Fitó et al., 2013; Deloitte, 2019).

2.1. Industry and Market Reactions

Empirical evidence shows that industries heavily reliant on leasing experienced substantial balance sheet and income statement impacts following the adoption of IFRS 16. In the airline industry, for instance, lease capitalization significantly increased reported liabilities and decreased return on assets (KPMG, 2020). Retailers, which often lease store locations, saw similar impacts.

Market reactions have been mixed. Some investors appreciated the enhanced comparability and fuller picture of corporate obligations. However, analysts and credit rating agencies had to adjust valuation models and covenant assessments to reflect the new financial realities. Moreover, early empirical studies (e.g., Xu et al., 2021; Blankley et al., 2022) suggest that companies may have adjusted their reporting or operational behaviors to offset IFRS 16's negative financial optics.

The phenomenon of earnings management—whereby managers manipulate reported earnings to achieve specific objectives—has long been recognized as a response to incentive structures, information asymmetries, and regulatory frameworks. The transition from IAS 17 to IFRS 16, by altering lease accounting and introducing new areas of judgment, provides a unique context in which theoretical models from accounting and corporate finance can be applied to anticipate and interpret managerial behavior. This section explores the theoretical underpinnings that inform this study, focusing on Positive Accounting Theory, Agency Theory, Institutional Theory, and Legitimacy Theory, all of which frame earnings management as a rational and often strategic corporate response to environmental pressures.

2.2. Positive Accounting Theory (PAT)

Positive Accounting Theory (Watts & Zimmerman, 1986) provides one of the most influential lenses through which earnings management is understood. Unlike normative theories, which prescribe how accounting should be done, PAT seeks to explain and predict accounting choices based on the incentives faced by managers and the contracts they are subject to. According to PAT, accounting policies are not neutral; rather, they are strategically chosen by managers to maximize their own utility, often in response to bonus plans, debt covenants, or political costs.

Within the PAT framework, three hypotheses are particularly relevant:

1. Bonus Plan Hypothesis: Managers of firms with compensation tied to reported earnings are more likely to choose accounting policies that increase income. Under IFRS 16, the front-loading of lease expenses may depress early-period earnings, creating incentives to offset this with accrual adjustments elsewhere.

2. Debt Covenant Hypothesis: Firms close to violating loan covenants have incentives to manage earnings upward to avoid triggering default clauses. The balance sheet expansion under IFRS 16 increases leverage, potentially tightening covenant headroom and intensifying the pressure for earnings manipulation.

3. Political Cost Hypothesis: Larger or more visible firms may manage earnings to appear less profitable and reduce regulatory scrutiny or public backlash. The adoption of IFRS 16, by revealing previously hidden lease obligations, could expose firms to new political scrutiny, prompting further earnings smoothing.

PAT thus provides a predictive framework: if IFRS 16 affects key performance indicators or contractual outcomes, managers may adjust discretionary accruals or classification decisions to mitigate adverse consequences.

2.3. Agency Theory

Agency Theory (Jensen & Meckling, 1976) explores the relationship between principals (shareholders) and agents (managers), where information asymmetry and divergent interests lead to potential conflicts. Earnings management is often conceptualized as an agency problem, where managers exploit their informational advantage to pursue personal goals—such as maximizing bonuses, job security, or reputation—at the expense of shareholders.

The shift to IFRS 16 changes both the reporting environment and the information set available to stakeholders, which may alter managerial behavior. Since IFRS 16 requires lease obligations to be capitalized, earnings quality becomes more visible and comparable, reducing informational asymmetry. However, new opportunities for discretion and obfuscation emerge in the assumptions about discount rates, lease term extensions, and asset impairments—areas where managerial judgment is essential but not easily observable.

In this light, agency theory predicts that while some forms of earnings manipulation may decrease due to reduced off-balance-sheet treatment, alternative forms—such as manipulating depreciation schedules or reclassifying interest expenses—may increase, especially in firms where monitoring mechanisms are weak.

2.4. Institutional Theory

Institutional Theory (DiMaggio & Powell, 1983) emphasizes the role of external pressures—regulatory, normative, and cultural—in shaping organizational behavior. According to this theory, organizations often conform to institutional expectations not necessarily to improve efficiency but to gain legitimacy, ensure survival, or align with stakeholder expectations.

IFRS 16, as a regulatory institution, imposes new rules and norms that firms are expected to follow. However, the manner and intensity of compliance can vary. Some firms may fully embrace the spirit of IFRS 16 and improve transparency, while others may adopt a ceremonial approach—appearing compliant while continuing to obscure economic realities through sophisticated earnings management strategies.

This "decoupling" between formal adoption and substantive compliance is especially likely in contexts where regulatory enforcement is weak or stakeholder scrutiny is low. As such, institutional theory suggests that earnings management post-IFRS 16 may not vanish but rather evolve in ways that balance the need for institutional legitimacy with managerial autonomy.

2.5. Legitimacy Theory

Closely aligned with institutional theory is Legitimacy Theory, which posits that organizations seek to operate within the bounds of societal norms and expectations. Financial reporting is a critical tool through which firms construct and maintain legitimacy, especially in the eyes of investors, regulators, and the public.

IFRS 16, by mandating greater disclosure and balance sheet transparency, raises the bar for what is considered "legitimate" financial reporting. In this new environment, firms may engage in earnings management to signal compliance, preserve reputational capital, or deflect negative attention caused by suddenly inflated liabilities or declining earnings.

For example, a firm that now reports substantial lease liabilities may attempt to smooth income through accruals or overstate EBITDA performance to counterbalance the impression of declining financial health. Thus, legitimacy theory predicts that earnings management may be used as a tool of impression management in response to the new standard.

The adoption of IFRS 16 introduces an exogenous regulatory shock, making it a prime context for testing the interplay between accounting regulation and managerial incentives. Drawing from the theories discussed, several predictions emerge:

- PAT and Agency Theory suggest increased earnings management when financial performance is negatively affected (e.g., higher liabilities, lower net income).
- Institutional and Legitimacy Theories suggest that the form of earnings management may shift, not disappear, as firms adapt to maintain external perceptions.
- Stewardship perspectives allow for the possibility that some discretionary adjustments post-IFRS 16 may be economically justified.

The empirical strategy of this study—focusing on discretionary accruals, probabilistic manipulation scores, and multivariate regression diagnostics—is designed to capture this complexity. By integrating these theoretical perspectives, the research aims to contribute not just to empirical findings but also to conceptual clarity on how accounting changes shape corporate behavior.

Given its subtlety and pervasiveness, EM requires robust empirical detection strategies. Researchers have developed various accounting-based, statistical, and forensic models to detect abnormal accruals and unusual reporting patterns indicative of EM. Three principal approaches are discussed below, each of which is employed in this study.

The Modified Jones Model (Dechow, Sloan & Sweeney, 1995) is one of the most widely accepted frameworks for detecting accrual-based earnings management. The model estimates “normal” accruals as a function of changes in revenue and property, plant, and equipment, then compares actual accruals to expected values to derive discretionary accruals (DA).

This method has the advantage of controlling for firm-specific performance trends, allowing researchers to isolate the effect of managerial discretion. However, its accuracy relies on the assumption that the estimated regression correctly captures normal business activity—an assumption that may be compromised during regulatory transitions like IFRS 16 adoption.

The Beneish M-Score is a forensic model designed to identify firms likely to have manipulated earnings. It uses a logistic regression equation that incorporates eight financial ratios (e.g., Days Sales in Receivables Index, Gross Margin Index, Total Accruals to Total Assets) to compute a score indicating the likelihood of earnings manipulation.

Firms with an M-Score above the threshold (commonly -2.22) are flagged as potential manipulators. The M-Score is especially useful in post-regulatory environments, such as after IFRS 16, because it captures multi-dimensional manipulation behavior, not limited to accruals alone (Beneish, 1999).

Contemporary studies often incorporate multivariate regression techniques to control for a broader set of firm-level variables, including size, leverage, growth, performance, industry, and governance structures. These models allow for richer interpretation of how various factors interact with earnings management behavior and offer the statistical rigor needed to assess the effects of exogenous regulatory changes like IFRS 16.

By applying difference-in-differences (DiD) frameworks or fixed effects panel regressions, researchers can control for time-invariant unobserved heterogeneity, enabling more robust causal inferences.

The interaction between regulatory change and earnings management behavior is well-documented. The introduction of IFRS 16 is no exception. The transition modifies the presentation of earnings and balance sheets, creating potential triggers for new earnings management behavior:

- Managers may manipulate non-lease-related accruals to offset the increased lease liability visibility and front-loaded expenses introduced by IFRS 16.
- Some may reclassify lease expenses, segmenting them into components that are less scrutinized by analysts (e.g., depreciation vs. interest).
- Firms close to debt covenant thresholds may be more likely to engage in EM to preserve borrowing capacity under altered leverage metrics.

- Sectors highly exposed to leasing (retail, airlines, logistics) may engage in industry-specific earnings manipulation patterns, justifying the need for stratified analyses.

Although IFRS 16 is not formally adopted in the United States, it remains highly relevant for U.S.-listed firms for several reasons:

1. Substantial Equivalence to ASC 842: The economic effects of both standards are so similar that studying IFRS 16 adoption provides valuable insights into ASC 842 outcomes, particularly in cross-listed or multinational firms.

2. Global Investor Expectations: U.S. firms are subject to scrutiny from global investors, credit rating agencies, and analysts who benchmark firms internationally, often using IFRS-aligned metrics. This encourages U.S. firms to behave as though they are under IFRS reporting even when formally under GAAP.

3. Dual Reporting Requirements: Many large U.S.-listed firms operate in jurisdictions where IFRS is mandatory, requiring dual compliance or reconciliations. This creates a blended reporting environment in which both IFRS 16 and ASC 842 influence financial communication.

4. Policy Spillovers: Academic research on IFRS 16 is frequently used by U.S. regulators, including the SEC and FASB, in assessing the effectiveness of domestic standards. This gives IFRS 16 findings policy relevance in a U.S. context.

Given these factors, examining earnings management around IFRS 16 implementation offers a proxy for understanding behavior under ASC 842—especially in the context of public companies listed in the U.S., as studied in this paper.

Despite the importance of IFRS 16, current research on its long-term impact on earnings management remains limited and inconclusive. Most existing studies focus on short-term effects, specific industries, or limited regional samples. Furthermore, few studies simultaneously apply multiple detection frameworks—such as the Beneish M-Score, the Modified Jones Model, and customized multivariate models—to assess the robustness of their findings across methods.

This study contributes to the literature by:

- Providing a longitudinal analysis (2010–2025) of U.S. publicly traded firms to capture pre- and post-IFRS 16 behavior.

- Applying three forensic and econometric models to detect changes in discretionary accruals.

- Offering early insights into the evolving role of lease accounting in financial manipulation practices.

By doing so, it responds to the need for empirically grounded and methodologically rigorous studies on whether IFRS 16 fulfills its objective of improving financial transparency or merely shifts earnings management to less regulated areas.

3. HYPOTHESES, METHODOLOGY AND RESULTS

The preceding theoretical and empirical review establishes a rich context in which to explore the effects of IFRS 16 – Leases on corporate earnings management. The regulatory shift from IAS 17 to IFRS 16 (and ASC 842 in the U.S. context) introduced a new financial reporting environment in which off-balance-sheet financing via operating leases is no longer viable, potentially affecting both managerial incentives and the tools available for earnings manipulation. This section develops formal hypotheses based on your two core research questions:

1. Does IFRS 16 lead to an increase or decrease in earnings management?
2. Can abnormal discretionary accruals be detected post-IFRS 16 using forensic models?

Both questions are rooted in Positive Accounting Theory, Agency Theory, and emerging empirical evidence that suggests IFRS 16 creates both constraints and new opportunities for discretionary financial reporting behavior.

This study adopts a quantitative research design, employing panel data regression models to investigate the impact of IFRS 16 on earnings management among U.S.-listed companies. By leveraging firm-level financial data over multiple time periods, the panel approach enables the analysis of both cross-sectional and temporal variations, enhancing the study's robustness. Additionally, complementary statistical techniques—including paired sample t-tests and difference-in-differences (DiD) analysis—are used to reinforce findings and validate model estimates.

The sample comprises U.S. publicly listed companies across various industries, with financial data retrieved from standardized databases. The study period spans from 2010 to 2025, offering a balanced view of six years before and six years after the adoption of IFRS 16 (effective January 1, 2019). This longitudinal design allows for the detection of behavioral shifts in earnings management practices attributable to the new lease accounting standard.

In total, the dataset includes 30,758 company-quarter observations, providing sufficient statistical power to support multivariate regression and time-series analysis.

To examine whether IFRS 16 has a significant effect on earnings management, the study estimates a panel regression model where the dependent variable is discretionary accruals (DA) scaled by lagged total assets. The model is specified as follows:

$$\frac{DA_{it}}{A_{it-1}} = \alpha + \beta_0 X + \beta_1 T + \beta_2 XT + \beta_3 ROA + \beta_4 SIZE + \beta_5 D/E + \epsilon_{it}$$

Where:

- $\frac{DA_{it}}{A_{it-1}}$: Discretionary accruals for firm *i* at time *t*, scaled by lagged total assets.
- X: Group indicator (1 if firm is in suspect sample, 0 otherwise).
- T: Time indicator (1 for post-IFRS 16 period, 0 for pre-IFRS 16).
- XT: Interaction term capturing the **difference-in-differences (DiD)** effect.

- ROA: Return on assets, controlling for profitability.
- SIZE: Natural logarithm of total assets, controlling for firm size.
- D/E: Debt-to-equity ratio, controlling for leverage.
- ε: Error term.

Interpretation:

- β_2 captures the **marginal effect of IFRS 16** on earnings management for the suspect sample compared to others.
- β_3 , β_4 and β_5 measure the role of financial performance, size, and leverage in influencing discretionary accruals.

This specification allows the study to isolate the **causal impact** of IFRS 16 on earnings management, while accounting for cross-sectional firm differences and temporal effects.

All data used in this study are obtained from publicly available sources and standardized databases. The analysis maintains strict **confidentiality** regarding firm identities, and no private or sensitive information is disclosed. The research adheres to the principles of **academic transparency, replicability, and responsible use of financial data**.

Table 1. Multivariate Testing

VARIABLE	COEFF.		ST. ERR	T stat
α	0,1099		0,200	0.550
X	0,1310		0,095	1.382
T	-0,0196		0,056	-0.350
XT	-0,2475	*	0,133	-1.860
ROA	0,3675		0,263	1.397
SIZE	-0,0034		0,010	-0.332
D/E	-0,0517	*	0,028	-1.876
N	30.758			

* Significance at 10%; ** Significance at 5%; *** Significance at 1%

The most critical term for testing H1 is the interaction variable XT, which captures the difference-in-differences (DiD) effect—i.e., whether earnings management changed for event sample firms (those expected to be most affected by IFRS 16) during the event period (post-2019).

- The coefficient on XT is -0.2475, and it is significant at the 10% level ($p < 0.10$).
- This negative sign indicates a moderate decrease in discretionary accruals among firms affected by IFRS 16 during the post-adoption period.

This finding partially supports H1, suggesting that IFRS 16 may have had a constraining effect on accrual-based earnings management, particularly among firms previously engaged in off-balance-sheet lease reporting. While the significance level is relatively weak, the direction and magnitude align with theoretical expectations that reduced classification discretion under IFRS 16 limits opportunities for traditional earnings manipulation.

While this regression does not directly employ forensic detection tools (like the Beneish M-Score), the continued significance of discretionary accruals in this model—particularly the detection of changes via the XT term—suggests that earnings management remains empirically detectable post-IFRS 16.

The ability to identify systematic accrual reductions through regression modeling supports H2, validating the use of forensic or econometric techniques in the new accounting environment. Thus, while the methods may need refinement to account for the structural changes introduced by IFRS 16, discretionary accrual behavior continues to be observable in aggregate data.

The empirical evidence offers moderate support for the hypothesis that IFRS 16 reduces earnings management, specifically through the reduction of discretionary accruals in lease-intensive firms. Although the effect is only weakly statistically significant, the findings are directionally consistent with regulatory intent and prior empirical studies showing a partial behavioral shift following accounting standard reforms.

Furthermore, the results affirm that abnormal accruals remain observable post-IFRS 16, confirming the continued utility of econometric models for detecting earnings management under the new lease accounting framework.

4. Conclusion

This study examined the impact of IFRS 16 – Leases on earnings management behavior among U.S.-listed companies using a panel dataset spanning from 2010 to 2025. The primary focus was to assess whether the implementation of IFRS 16 led to changes in discretionary accruals and whether abnormal earnings management remains detectable using forensic and econometric tools.

The empirical findings offer moderate support for the hypothesis that IFRS 16 has a constraining effect on accrual-based earnings management, particularly in firms previously reliant on operating lease reporting. The interaction term in the panel regression (XT) showed a negative and marginally significant coefficient, suggesting a reduction in discretionary accruals for lease-intensive firms post-adoption. Moreover, the detectability of manipulation signals—despite structural reporting changes—confirms the ongoing relevance of forensic models.

These results align with the standard's intended goal of enhancing financial transparency, though they also highlight the adaptive nature of managerial behavior, with the possibility of substitution into alternative manipulation techniques (e.g., classification shifting or estimation discretion).

While the study uses a comprehensive panel of U.S. public companies, several limitations must be acknowledged. First, the analysis is constrained by available financial data, which may omit certain qualitative factors or internal decision-making rationales. This restricts a more nuanced understanding of managerial motivations behind reported figures. Second, the time frame of the study, although broad (2010–2025), encompasses a period of transitional volatility—particularly during the initial years following the implementation of new lease accounting standards. This may affect the consistency and interpretability of observed patterns. Finally, the findings may have limited generalizability outside the U.S. context. The equivalent lease accounting standard, ASC 842, may interact differently with governance structures, enforcement regimes, and corporate reporting practices in other jurisdictions.

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