IFRS adoption, enforcement changes, and the quality of financial reporting: The particular case of South Africa

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THE STUDY BACKGROUND

- Effective 1 January 2005, listed firms in SA, the EU, Australia, New Zealand and other countries were required to prepare financial statements (FSs) in compliance with IFRS.
- The claimed benefits of IFRS adoption include:
  - increased transparency,
  - timelier loss recognition,
  - having more comparable FSs internationally,
  - increased cross-border investments,
  - reduction in cost of capital, and
  - increased quality of accounting information (e.g., Ball, 2016; Daske et al., 2008).
- Many empirical studies have sought to examine the effects of IFRS adoption on financial reporting, capital markets, and economic outcomes (see reviews by Bruggemann et al., 2013; De George et al., 2016; Leuz & Wysocki, 2016, for example).
- Overall, the evidence is that IFRS adoption brings significant financial reporting, capital market, and economic benefits to adopting firms and countries.

STUDY MOTIVATION

- Hitherto, the literature and the evidence is dominated by the EU setting.
- There are two major contamination or identification concerns associated with the EU setting.
  - First, the IFRS adoption occurred concurrently with the introduction of regulations (e.g., insider trading) unrelated to IFRS adoption, but have the potential to also affect capital market outcomes (e.g., Christensen et al., 2013; De George et al., 2016).
  - Second, in many EU countries, IFRS adoption also occurred concurrently with changes in financial reporting enforcement, which was meant to ensure compliance with IFRS (see Daske et al., 2008; Christensen et al., 2013; Leuz & Wysocki, 2016).
  - We contend that the second concern is also true for Australia (see Brown and Tarca, 2007).
- Consequently, the <u>evidence does not show us the effects of IFRS adoption per se</u> but shows us the <u>**JOINT effects**</u> of IFRS adoption and changes in enforcement and other regulations (Barth & Israel, 2013).

STUDY MOTIVATION - Continued

- Our innovative SA setting avoids the identification problem by having two “natural experiments”, which staggers the adoption of IFRS and changes in enforcement.
- Although SA adopted IFRS for listed firms effective from 1 January 2005 (first natural experiment), substantive IFRS enforcement changes were only introduced in 2011 (second natural experiment).
- The SA Companies Act (No. 71 of 2008), which became effective 1 May 2011, made several changes meant to enforce compliance with IFRS and other financial reporting regulations.
- These enforcement changes include the following:
  - Requiring (for the first time) state owned and public companies to prepare FSs in conformity with IFRS, thus providing legal backing for their enforcement.
  - The creation of a statutory body (the CIPC) that:

    (a) monitors and enforces compliance with IFRS and other financial reporting requirements; and

    (b) has the power to issue and enforce compliance notices and to refer alleged offences for prosecution.

STUDY MOTIVATION - Continued

- These enforcement changes include the following (**continued**):
  - The new Act introduced auditor rotation by providing that an individual auditor may not audit the same company after five consecutive years.
    - This strengthens the auditor's independence and effectiveness in enforcing compliance with IFRS and other financial reporting regulations.
  - The new Act also requires state owned and public companies to establish audit committees (ACs) comprising of independent NEDs.
    - These ACs are responsible for nominating external auditors, determining audit fees, and determining and pre-approve the nature and extend of non-audit services.
- In February 2011, the JSE made the following changes:
  - The GAAP Monitoring Panel (GMP) was converted to the Financial Reporting Investigation Panel (FRIP).
  - The FRIP started a process of **proactively** reviewing AFSs for compliance with IFRS, which was contrary to the **reactive** approach used by the GMP (e.g., World Bank, 2013).
- Our unique SA setting allows us to **separately** examine the effects of IFRS adoption and enforcement changes on financial reporting, capital markets, and economic outcomes.

RESEARCH OBJECTIVES AND DESIGN

- The objectives of this study are three-fold. These are:
  - First, we examine whether the adoption of IFRS is associated with an improvement in accounting quality operationalize by the value relevance metric.
    - This entails comparing the value relevance of accounting amounts <u>in the pre-IFRS adoption period</u> (2002-2004) and <u>the post-IFRS adoption period</u> (2006-2012).
  - Second, we examine whether the enforcement changes of 2011 is associated with an increase in the value relevance of accounting amounts.
    - This entails comparing the value relevance of accounting amounts **(post-IFRS adoption)** <u>in the sub-periods before legal enforcement</u> (2006-2010) and <u>after legal enforcement</u> (2010-2012).
  - Third, we also examine the effect of the 2008 global financial crisis on the value relevance of accounting amounts.
    - This involves comparing the value relevance of accounting amounts in the <u>pre-crisis period</u> (2005-2006), <u>during the crisis period</u> (2007-2009), and the <u>post crisis period</u> (2010-2012).

RESEARCH METHODOLOGY

- **SAMPLE:** We use a balanced sample of 114 firms (1 254 firm-years) covering the period 2002-2012, after eliminating financial firms, outliers and firms with missing data.
  - The population comprised of 326 firms listed on the JSE as at 31 December 2012.
- **MODEL:** The adoption of IFRS affects both earnings and items on the statement of financial position (Barth et al., 2001; Chalmers et. al., 2011). Hence, our main model is the price model, specified as follows:
  - $\mathbf{Price_{it} = \alpha_0 + \alpha_1 BVPS_{it} + \alpha_2 EPS_{it} + \alpha_3 YearDummies + \varepsilon_{it}}$
- **DATA SOURCES:** Data for the study were obtained from the McGregor BFA Database.
- **ANALYSIS:** Panel data methodology was selected, and the fixed effects linear regression model was conducted to control for time invariant factors.

THE DESCRIPTIVE STATISTCS

	Mean	Standard Deviation	Min	Max
PANEL A: ENTIRE SAMPLE 2002-2012 (N=1254)				
4 Months Share Price	41.45638	82.14682	0.01	1178.62
BVPS	2020.707	3358.31	-488.912	32550.45
EPS	339.5265	838.1877	-1880	13772
PANEL B: PRE-IFRS PERIOD 2002-2004 (N=342)				
4 Months Share Price	19.28149	33.15807	0.01	232.32
BVPS	1275.776	2211.289	-488.912	16040.11
EPS	233.3308	609.1721	-383.8	6863
PANEL C: POST-IFRS PERIOD 2006-2012 (N=798)				
4 Months Share Price	51.99075	95.80665	0.02	1178.62
BVPS	2401.711	3736.779	-412.847	32550.45
EPS	392.422	941.7298	-1880	13772

DESCRIPTIVE STATISTICS - CONTINUED

	Mean	Standard Deviation	Min	Max
PANEL D: POST-IFRS (TRANSITIONAL PERIOD): 2005-2006 (N=228)				
4 Months Share Price	47.75839	96.49445	0.04	1178.62
BVPS	2205.802	3313.855	-19.4133	27946.63
EPS	419.1763	1164.601	-1880	13772
PANEL E: POST-IFRS (FINANCIAL CRISIS PERIOD): 2007-2009 (N=342)				
4 Months Share Price	57.40357	88.41678	0.04	667
BVPS	2741.228	4232.298	-18.8544	32550.45
EPS	366.6198	678.5822	-1030.4	6243
PANEL F: POST-IFRS (POST-FINANCIAL CRISIS PERIOD): 2010-2012 (N=342)				
4 Months Share Price	41.34491	93.17773	0.02	1113.01
BVPS	1779.678	3126.609	-459.42	21529.95
EPS	338.7053	750.8244	-408	6006

RESULTS: PRE-IFRS, TRANSITIONAL & POST-IFRS PERIODS

$Price_{it} = \alpha_0 + \alpha_1 BVPS_{it} + \alpha_2 EPS_{it} + \alpha_3 YearDummies + \varepsilon_{it}$			
VARIABLES	**Panel B: 2002-04**	**2005**	**Panel C: 2006-12**
BVPS	0.00581	0.00810	0.0155
	(4.564)***	(2.219)**	(16.08)***
EPS	0.00689	0.00985	0.00952
	(1.492)	(0.541)	(2.489)**
Constant	8.173	18.54	14.14
	(2.884)***	(2.889)***	(2.090)**
Observations	342	114	798
Adjusted R^2	0.243	0.180	0.454
F test	28.31	13.40	83.77

*** Significant at 1%, ** significant at 5% and * significant at 10%.

RESULTS: PRE- AND POST-LEGAL ENFORCEMENT PERIODS

$Price_{it} = \alpha_0 + \alpha_1 BVPS_{it} + \alpha_2 EPS_{it} + \alpha_3 YearDummies + \varepsilon_{it}$

Variables	**Pre-Legal Enforcement Period (2006-2010)**	**Post-Legal Enforcement Period (2011-2012)**
BVPS	1.6200	1.1200
	(11.96)***	(10.68)***
EPS	0.3700	5.3200
	(0.789)	(8.195)***
Constant	1.126	821.0
	(1.451)	(1.796)*
Observations	570	228
Adjusted R^2	0.375	0.755
F test	57.93***	234.5***

*** Significant at 1%, ** significant at 5% and * significant at 10%.

RESULTS: POST-IFRS TRANSITIONAL, CRISIS AND POST-CRISIS PERIODS

$Price_{it} = \alpha_0 + \alpha_1 BVPS_{it} + \alpha_2 EPS_{it} + \alpha_3 YearDummies + \varepsilon_{it}$

VARIABLES	**Panel D: 2005-06**	**Panel E: 2007-09**	**Panel F: 2010-12**
BVPS	-0.00137	0.0198	0.0126
	(-0.464)	(11.04)***	(11.50)***
EPS	0.0780	-0.00723	0.0314
	(6.362)***	(-1.415)	(4.591)***
Constant	13.95	20.55	11.39
	(1.855)*	(2.723)***	(2.198)**
No. of Obs.	228	342	342
Adjusted R^2	0.345	0.383	0.652
F test	40.81	53.97	160.7

*** Significant at 1%, ** significant at 5% and * significant at 10%.

RESULTS SUMMARY & CONCLUSIONS

- The results suggest that accounting information was value relevant both in the pre- and post-IFRS adoption periods. However, the information appear to be more value relevant in the post-IFRS period, when compared to the pre-IFRS period.
  - Adjusted R^2 of 24.3% pre-, compared to 45.4% post-IFRS period.
- Also, in the pre-IFRS period, only the BVPS was value relevant (at 1%), while both BVPS and EPS were value relevant in the post-IFRS adoption period (at 1% and 5% levels, respectively).
- In the post-IFRS adoption period, the value relevance of both the BVPS and EPS is greater in the post-legal enforcement period compared with the pre-legal enforcement period.
  - Adjusted R^2 of 75.5% in the pre-legal enforcement sub-period, compared with 37.5 in the post-legal enforcement period.
- Overall, the evidence suggests an increase in the value relevant of BVPS and EPS in: (1) the post-IFRS adoption period compared with the pre-IFRS period; and (2) the post-legal enforcement period compared to the pre-legal enforcement period.