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The impact of regulatory reform on the value-relevance of accounting information: Evidence from the 1993 regulatory reforms in New Zealand

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A B S T R A C T

This paper examines the impact of the 1993 financial reporting regulatory reforms in New Zealand on the value-relevance of accounting information. The study achieves this by regressing stock data of companies on book values and earnings for the pre- and post-regulatory periods. The Financial Reporting Act of 1993 was enacted in New Zealand as part of a wider package of company law reform. The 1987 share market collapse led to a Ministerial Committee of Inquiry that criticised the quality of financial reporting and the high level of non-compliance with accounting standards. The Committee recommended establishing an Accounting Standards Review Board to give the accounting standards a force of law. Whether this development increases the value-relevance of accounting information is an empirical question. The results, however, fail to find any significant increase in the total value-relevance of accounting information in the post-regulation period. There is, however, a corresponding increase in the incremental explanatory power of equity book values in the post-regulation period. This study also extends extant research on the effect of regulation on the value-relevance of accounting information by incorporating firm-specific factors to isolate the effect of regulation.

1. Introduction

The purpose of this paper is to investigate whether the 1993 regulatory reforms in New Zealand have had a discernible impact on the relevance of accounting numbers subsequent to promulgation. The Financial Reporting Act (1993) (hereafter FRA) was enacted in New Zealand as part of a wider package of company law reform. The Act places an obligation on certain entities to prepare financial statements and provide these statements to the Registrar of companies. In addition, the Act establishes a body, the Accounting Standards Review Board (ASRB) which is charged with prescribing the requirements for financial reporting by those entities, and giving these requirements the force of law.

With the introduction of any reporting regulation, the question that inevitably arises is whether accounting regulation is effective or not. That is, do companies provide credible information to market participants even in the absence of regulation? Proponents of a free-market perspective on accounting regulation argue that accounting information should be treated like any other goods or services and that demand and supply forces should be allowed to determine the optimal supply of accounting information. They derive their argument from Coase (1960), who states that when property rights are well defined and "transaction costs" are zero, market participants will organize their transactions in ways that will achieve efficient outcomes (see also Easterbrook & Fischel, 1991; Stigler, 1964).

The pro-regulation perspective, on the other hand, suggests that regulation is necessary because of market failure for public goods. This theoretical model further suggests that mandatory disclosure can be beneficial when the costs of writing or enforcing contracts that bind managers to maximize shareholder value are prohibitively high. The empirical literature provides mixed evidence on the market impact of mandatory regulatory requirements on disclosure practices. Barton and Waymire (2004) examine the extent to which managers, without a regulatory mandate, supply higher quality financial reporting to mitigate investor losses during a financial crisis. Using data from the 1929 United States of America (U.S.A.) stock market, they find that contracting and control conflicts induce managers to provide high-quality information even in the absence of regulation and that firms with high-quality information suffered less during the stock market crash. Greenstone, Oyer and Vissing-Jorgensen (2006), on the other hand, find positive market reactions to the 1964 Securities Acts amendments. Evidence from the recent, comprehensive governance legislation, the Sarbanes–Oxley Act of 2002 (SOX 2002) is mixed, with Chhaochharia and Grinstein (2007) finding positive market effects of the SOX (2002) on firm value, while Zhang (2007) reports the opposite. Consistent with Zhang (2007), Bhattacharya, Groznik and Haslem (2007) find that CEO certification mandated by SOX (2002) is not value-relevant.[1]

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[1] The Foreign Corrupt Practices Act (FCPA), a pre-cursor to Sarbanes–Oxley, was designed to restore confidence in American companies doing business overseas. The FCPA was enacted in 1977 in response to several scandals involving bribes of foreign officials.

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While regulatory authorities may believe that enhancing the relevance of financial information is desirable, there can be significant impediments to achieving such a goal. Ely and Waymire (1999) state that:

> … information relevance is likely a complex, multidimensional attribute and standard-setters may not reach consensus on which specific methods will enhance relevance… Second, the relevance of accounting data may be influenced by changes in the economic environment beyond the standard setter's control… Hence they may play a continual game of "catch-up" where new standards are required merely to keep pace with changing external circumstances. Finally, standard-setting is a political process… As such, standard-setters may be required to trade off relevance against the need to satisfy multiple constituencies with conflicting interests (p. 295).

This paper explores the impact of regulatory reform on the value-relevance of accounting information. An accounting number is deemed to be value-relevant if it is significantly related to stock price (the measure of value) (Beaver, 2002). Beaver (2002, 460) also states that, "value-relevance research demands an in-depth knowledge of accounting institutions, accounting standards, and the specific features of the reported numbers". Regulation aimed at enriching these aspects, therefore, requires careful scrutiny. The FRA, which was enacted in New Zealand in 1993 and is examined in this study, is an example of such regulation. The FRA, through the enforcement regime of the ASRB, has an important role to play in the provision of accounting information in New Zealand. With adoption of International Financial Reporting Standards (IFRSs) became mandatory since January 2007, this enforcement regime assumes much greater importance, as good quality reporting standards will be of little use without a strong enforcement mechanism. No evidence, however, presently exists about the effectiveness of the FRA in this enforcement capacity and consequently whether accounting information that is more relevant to users has been provided since the promulgation of the FRA. This paper addresses this issue, by examining the impact – if any – of the promulgation of the FRA on the value-relevance of accounting information.

Using data from 38 companies that were listed on the New Zealand Stock Exchange during both the pre- and post-reform eras from 1990 to 1999, this study fails to find any significant increase in the value-relevance of accounting information (earnings and equity book values) in the post-regulation period. When the value-relevance of accounting information is decomposed into equity book values and earnings components, the evidence suggests a significant increase in the incremental explanatory power of equity book values in the post-regulation period, but not in the incremental power of earnings. These findings, however, may not be due solely to regulatory reform, as the relevance of accounting data may also have been influenced by firm-specific economic factors. Four such factors, which have been shown to affect changes in the value-relevance of accounting information, are identified and their impact on the pricing of earnings and equity book values estimated. Regression results reveal that the firm-specific variables have a much higher explanatory power for stock prices than the baseline regression model.

The incorporation of firm-specific economic variables in analyzing the impact of regulation on the valuation properties of accounting information is an advance on the existing literature. Earlier empirical studies on the impact of regulatory reform on the value-relevance of accounting information (Ballester & Livnat, 1997; Ely & Waymire, 1999; Giner & Rees, 1999) are based on a simple comparison of the adjusted R^2s in the pre- and post-regulatory periods. This change in adjusted R^2s, however, is difficult to attribute to changes in regulatory reform if other fundamental economic factors that could affect the value-relevance of accounting information remain uncontrolled. This study addresses this issue.

2. Financial Reporting Act (1993) and relevance of accounting information

The FRA was enacted in New Zealand as part of a wider package of company law reform, which included the Companies Act of 1993. The Act places an obligation on certain entities to prepare financial statements that comply with generally accepted accounting practice (GAAP) and give a true and fair view of their affairs and to provide these statements to the Registrar of Companies. In addition, the Act establishes a body, the Accounting Standards Review Board (ASRB), which is charged with prescribing the requirements for financial reporting by those entities and giving these requirements the force of law (Ministry of Economic Development of New Zealand Discussion document, 2004, p. 1). With the establishment of the ASRB, it could be expected that the enforcement of accounting standards would be higher in the post-1993 regime than in the pre-93 regime. As the quality of financial accounting information is a function of both the quality of accounting standards and the regulatory enforcement of their application by companies, without adequate enforcement, even the best accounting standards will be inconsequential (Hope, 2003, p. 238).

Until 1993, the regulation of the accounting profession in New Zealand was in the hands of the private sector, with the New Zealand Society of Accountants (hereafter NZSA) responsible for the development and issue of accounting standards through the Financial Reporting Standards Board (FRSB), a committee appointed by the council of the NZSA.[2] The enforcement of accounting standards by the NZSA relied on persuasion and the requirement that members auditing entities' financial reports disclose any departures from standards. The 1987 share market collapse led to a Ministerial Committee of Inquiry that criticised the quality of financial reporting and the high level of non-compliance with accounting standards. The Committee prepared a report recommending that (i) legal backing be given to accounting standards; (ii) an Accounting Standards Review Board be established to approve accounting standards; and (iii) sanctions be put in place for non-compliance with standards (Deegan and Samkin, 2004, p. 5).

As a result of these recommendations, the package of company law reforms was enacted in 1993. According to section 3 (a) of the FRA, financial statements comply with generally accepted accounting practice if those statements comply with applicable financial reporting standards. To facilitate the development of new, and the revision of existing, accounting standards in New Zealand, the Statement of Concepts for General Purpose Financial Reporting (SC) was approved by the ASRB in 1993. The SC underlies the preparation of general purpose financial reports for external users, stating, in paragraph 1.1 (a), that one of its purposes is to assist users to interpret the information contained in financial reports prepared in conformity with GAAP.

The enactment of the FRA, with its definition of and provision for the further development of GAAP based on the SC, suggests that increasing the usefulness of financial statements was a primary motive for the regulatory reforms of 1993. If increased usefulness has been achieved by the new regulation, it could be argued that this should have resulted in the improved value-relevance of accounting information after the reforms.

As will be detailed later in the paper, the value-relevance of accounting information is measured by the ability of accounting information, particularly accounting earnings and equity book values, to explain the stock price of a particular company. Higher explanatory power, ceteris paribus, is presumed to imply higher relevance of accounting information. The FRA did not prescribe definite measurement and disclosure standards, but is oriented primarily towards

[2] The New Zealand Society of Accountants was renamed the Institute of Chartered Accountants of New Zealand (ICANZ) in 1996. ICANZ was subsequently renamed the New Zealand Institute of Chartered Accountants (NZICA).