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The impact of IFRS adoption on value relevance of earnings and book value of equity: the case of emerging markets in African and Asian regions

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Abstract

The purpose of this study is to examine the effect of mandatory adoption of International Financial Reporting Standards on the value relevance of earnings and the book value of equity. The evidence derived from the study suggested that despite the strength in the overall explanatory power of the model during the two periods, the role of EPS became observable in the post-adoption period. By conducting further analysis, the results highlighted that the increase of the value level are positively influenced by a common law legal system, a high level of external economic openness, a strong investor protection, a full protection of minority shareholders and by a sophisticated capital market.

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1. Introduction

The International Accounting Standards Board (IASB), as being the international accounting standard setting body, developed a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. Currently, more than 115 countries required or allowed the adoption of International Financial Reporting Standards (IFRS), or have established a calendar for the adoption of IFRS. In addition, developing countries and emerging economies such as South Africa and Turkey followed this

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wave of IFRS adoption. The adoption of IFRS by developing economies was polemic because on one hand, IFRS are considered as developed standards, which require a high level of economy development in order to be implemented successfully. On the other hand, developing countries are characterized by low human development indices, the predominance of the public sector and a relatively underdeveloped accounting profession. The first school of thought believes in the effectiveness of IFRS adoption by developing countries (Wallace, 1990; Larson, 1993; Joshi and Ramadhan, 2002). Some researchers and international organizations consider that IFRS are flexible enough to respond to the needs of developing countries (Carmona and Trombetta, 2008). By contrast, the other school of thought judge that IFRS are not suitable to developing countries because these standards are very complicated, highly developed standards and influenced by the Anglo-American culture (Hove, 1986; Perera, 1989).

Despite the growing adoption of IFRS by emerging economies (i.e. Turkey, South Africa, Mexico) and developing countries, little attention was assigned to study the consequences of IFRS adoption on value relevance in emerging economies (El Shamy and Kaled, 2005; Tsalavoutas, Andre and Evans, 2012; Kargin, 2013), focusing respectively on Kuwait, Greece and Turkey. Nevertheless, prior research investigating this topic focused more on developed countries, especially, European countries (Barth, Landsman and Lang, 2008; Callao, Jarne and La´inez, 2007; Devalle, Onali and Riccardo, 2010; Clarkson, P., Hanna, J. D., Richardson, G. D., and Thompson, R., 2011). Findings of previous research are mitigated. Some authors consider that IFRS can increase the level of value relevance (Barth et al., 2008; Karampinis and Hevas, 2011; Latridis, 2010). Some other studies reported that the adoption of IFRS decreased the degree of value relevance of earnings or/and book value of equity (Callao et al., 2007; Tsalavoutas et al., 2012).

The purpose of this study is to examine the effect of mandatory adoption of International Financial Reporting Standards on the value relevance of earnings and the book value of equity in emerging economies of African and Asian regions. We focus on value relevance considered as a market based measure of earnings quality.

According to Francis and Schipper (1999), value relevance is defined as the statistical association between financial information and prices or returns. In this study, the focus is on the association between price and financial information presented by book value of equity per share and earnings per share. In the first step of the analysis to estimate the price model for each country of the sample, year by year, after including firm level control variables (LEV, SIZE and GROWTH). Value relevance between pre and post-adoption periods will be compared to state about the effect of IFRS adoption on value relevance. These control variables are taken into account, because they were widely used in the literature of disclosure (Ben Othman and Zeghal, 2008), earnings management (Houqe, van Zijl, Dunstan, and Waresul Karim, 2012) and other accounting fields, but ignored somewhat in value relevance studies.

In the second step, a second equation is estimated which traces the effect of IFRS adoption and other country level control variables on value relevance. Unlike previous studies, country level control variables are considered when concluding about the effect of IFRS adoption on value relevance. The selected control variables are: the degree of external economic openness, the importance of capital markets of a country, the legal system, the strength of investor protection, the minority shareholders interest protection and the sophistication of financial market. Unlike prior studies, the interpretations of the impact of IFRS adoption on value relevance could be more robust, especially because the appropriate control variables in the second regression are given thorough focus.

The paper proceeds as follows. The next section presents the literature review. The research design is described in Section 3. Results are discussed in Section 4, followed by conclusions in Section 5.

1. 2. Literature review

Prior to the new focus of studies examining the effect of mandatory or voluntary adoption of IFRS on value relevance (Barth et al., 2008; Latridis, 2010; Clarkson et al., 2011; Tsoligkas and Tsalavoutas, 2011; Kargin, 2013), many studies examined the value relevance of earnings and/or book value of equity and other flow measures in different contexts (Phillip and Raffournier, 2010; Cheng, Lee and Yang, 2013; Chandrapala, 2013). Other studies concentrated on the effect of time on value relevance (Collins, Maydew and Weiss, 1997).

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