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Value Relevance of Accounting Items under IFRS: Theory and Review of Literature

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Abstract

This paper reviews existing literature in the field of value relevance in the context of new accounting standards i.e International Financial Reporting Standards both before and after introduction. The theory of value relevance research and contextual argument of the proposed impact of IFRS on accounting numbers has been discussed. The review suggests that there is no consensus in the existing literature regarding impact of IFRS on value relevance of accounting figures. The research identifies gaps in existing literature and concludes with scope of future research in this field.

Keywords: Accounting, IFRS, Relevance, Review.

Introduction

The International Financial Reporting Standards (IFRS) represent a major development in the field of international accounting and reporting. Though the financial statements cater to a wide variety of users, equity investors represent a majority class of those users. In the Exposure Draft on Conceptual Framework for Financial Reporting-Basis for Conclusion, the IASB states that both short term and long-term investors are considered to be primary users of financial statements.[1] Since, equity investors are primarily interested in information that can help them in share valuation, majority of academic research in this field is VR research. In fact, Relevance and Faithful representation are considered the fundamental qualitative characteristics of financial statements as purported by the Conceptual Framework issued by IASB. Faithful representation implies that financial statements adhere to the standards prescribed by IASB or relevant accounting body. As such, the most empirically tested qualitative characteristic is that of Relevance.

Value-relevance studies determine whether an accounting figure is significant to equity investors by measuring its contemporaneous relation with equity value i.e. share prices/returns. According

[1]BCIN.40, Basis for Conclusion on the Exposure Draft, Conceptual Framework For Financial Reporting (2015)

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to Francis and Schipper (1999), VR is measured by the extent to which financial statements contain information that influences share values. Mechelli and Cimini (2014) argue that "the investigation of the value relevance of accounting amounts is important in order to evaluate their usefulness, because it highlights whether they reflect information investors use in making economic decisions."

The conceptual framework of majority of studies is based on Ohlson model (1995) which provides a basis for linking earnings and book values to share prices / share value. This paper describes the theoretical framework for value relevance research and related literature.

Theoretical Framework

Hendrikson[2] defines Accounting Theory as "Logical reasoning in the form of broad principles that (1) provide a general frame of reference by which accounting practice can be evaluated (2) guide development of new practices and procedures." There are three main levels of accounting theory:

a) Structural Theories
b) Interpretational/Semantic Theories
c) Behavioural/Pragmatic Theories

These theories have been briefly discussed below:

a) Structural Theory

These theories attempt to explain current accounting practices and predict what accountants do. These theories are concerned with the mechanical tasks of converting inputs into output for reporting purpose. In this view, managers are regarded as stewards for the stakeholders and their purpose is to provide financial reports to stakeholders. Main writers in this field are Ijiri (1967) and Sterling (1975) and their main emphasis is on historical cost accounting with few exceptions. These theories are not concerned with usefulness of accounting numbers but focus on the means of reporting output as objectively as possible.

b) Interpretational Theory

These theories are concerned with linking accounting measurements with real world phenomena which the users can relate to. This theory emphasizes the use of accounting concepts in terms of human observations and experiences. Major writers in this field are Canning (1929) and Edwards and Bell (1961) who attempt to interpret accounting concepts in terms of economics. However, in accounting, measurements and resultant valuations are the result of application of specific accounting principles and not necessarily underlying concept.

c) Behavioural/Decision Usefulness Theory

Behavioural theory emphasizes the relevance of information being communicated for decision making of interested parties. These theories search for what are the objectives of financial

[2]Hendrikson, Accounting Theory (1984)

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reporting? Who are the primary users of accounting reports? Since, it is difficult to analyse the decision model of each individual, one way is to study the individual or group behavior caused as a result of accounting information. Individual user behaviour may be difficult to track as the decision models vary from one person to another and even if primary surveys are done, respondents themselves would not be able to describe their decision model. Hence, an alternative is to study the aggregate user behavior i.e. share prices. Thus, usefulness of accounting information is implied from the behavior of the market.

Theories of Investment Valuation

One of the purposes of accounting is to aid investors in reaching buy and sell decision. Prior to the development of Ohlson (1995) and Felham and Ohlson (1995) models, accountants borrowed theories from the finance world such as 'Intrinsic Value Theory'. As per this theory, investors will purchase a stock if its Intrinsic Value is greater than its market value. Intrinsic Value is what the investors consider to be the real worth of the stock. One basic approach to determine Intrinsic Value is the Dividend Discount Model. Under this approach, Intrinsic Value is considered as the present value of future expected stream of dividends. An inherent assumption is the investors' expectations about the future flow of dividends. Ohlson (1995) made an important contribution in this field and shifted the attention from dividends to accounting information. Ohlson expressed equity as a function of book value and future stream of expected abnormal profits based on a clean surplus relation and linear information dynamics.

Ohlson[3] Model

Ohlson model provides an alternative to traditional price explanation as a function of future expected dividends by linking equity value directly to accounting data without "explicit reference to dividends" (Bernard,1995) .

Beginning with the Dividend Discount model, the market value of equity is expressed as a function of future expected stream of dividends:

$$P_t = \sum_{\tau=1}^{\infty} R_f^{-\tau} E_t[d_{t+\tau}] \quad \text{(PVED)}$$

P_t = market value of firm's equity at time t

D_t= net dividend paid at time t net of capital contribution

R_f= risk free rate plus one

E_t [.]= the expected value operator conditioned on the date t information

Let

x_t = earnings for the period (t-1, t)

y_t= (net) book value at date t

[3]Earnings, Book Values and Dividends in Equity Valuation (1995) , Contemporary Accounting Research, 11 (2) pp 661-687

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As per the Clean Surplus Relation;

$$x_t = y_{t-1} - y_t + d_t \text{ or } d_t = x_t - y_{t-1} + y_t \quad (1)$$

Defining abnormal earnings as the earnings earned over and above the risk-free return on opening book value of equity:

$$x_t^a = x_t - (R_f - 1)y_{t-1} \quad (2)$$

Combining (1) and (2) and replacing x_t with x_t^a

$$d_t = x_t^a - y_t + (R_f)y_{t-1} \quad (3)$$

Using (3) to replace $d_{t+1}, d_{t+2,\ldots}$ in the PVED formula, gives the following equation

$$P_t = y_t + \sum_{\tau=1}^{\infty} R_f^{-\tau} E_t[x_{t+\tau}^{\sim a}] \quad (4)$$

The above relation can be interpreted as a firm's share price is equal to book value adjusted for the present value of expected abnormal earnings or the difference between market values and book values is equal to future profitability.

The final assumption concerns the behavior of abnormal earnings x_t^a and information other than abnormal earnings, v_t (value relevant events that are yet to have an impact on financial statements)

Assume $(x_\tau^{\sim a})$ $\tau_{\geq 1}$ satisfies the following stochastic process:

$$x_{\tau+1} = \omega x_t^a + v_t + \varepsilon_{1t+1}$$

$$v_{t+1} = \gamma v_t + \varepsilon_{2t+1} \quad (5)$$

where $\varepsilon_1\tau$, $\varepsilon_2\tau$ are unpredictable, zero-mean variables.

From (1) , (2) and (3) and the dyamics given in (5) , the linearity in specification leads to the following:

$$P_t = y_t + \alpha_1 x_t^a + \alpha_2 v_t \quad (6)$$

Where;

$$\alpha_1 = \omega / (R_f - \omega) > 0$$

$$\alpha_2 = R_f / (R_f - \omega)\ (R_f - \gamma) > 0$$

Using the definition of x_t^a and replacing y_{t-1} with the right-hand side of clean surplus equation, the valuation function (6) can be stated as:

$$P_t = k(\phi x_t - d_t) + (1-k)\, y_t + \alpha_2 v_t \quad (7)$$

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where

$$\Phi = R_f / (R_f - 1)$$

$$k = (R_f - 1)\ \alpha_1 = (R_f - 1)\ \omega / (R_f - \omega)$$

Equation (7) implies that equity is as a function of contemporaneous data where normal earnings replace abnormal earnings. The main contribution of Ohlson model is that links accounting data and equity value (Bernard, 1995).

Theory behind Accounting Standards (IFRS/IND-AS): Decision Usefulness

The emergence of decision usefulness perspective as a criteria for standard setting started in US in the late 1930s. In 1966, the American Accounting Association formed a committee to look into the accounting theory for standard setting. The Committee issued a Statement of Basic Accounting Theory (ASOBAT) which defined purpose of accounting as helping users make decisions and stated relevance as a primary characteristic of accounting information (Williams and Ravenscroft, 2015) . The report of the Committee is considered as a seminal work in the field of accounting thought. This criteria of "decision usefulness" was further formalized when AICPA issued the True Blood Report[4] (1973) that emphasized 'Decision Usefulness' as the objective of financial statements. Later, when the FASB was formed, the Conceptual Framework[5] explicitly stated that Financial Reporting should provide information that helps users in determining the future cash receipts.

Contextual Framework

The following features of IFRS may contribute to higher decision usefulness as compared to AS:

1. **Fair Value:** Historical Cost Accounting has been the basis of accounting measurement for decades. Supporters of this concept applaud it for being objective and reliable (Ijiri, 1967,1 971, 1981) . However, as standard setters around the world redefined the decision usefulness perspective of financial statements, the limitation of historical costs of being irrelevant for economic decision-making gained attention and search began for incorporating relevant and reliable figures in accounting reports. It is argued that historical cost accounting is not suitable for intangible assets and innovative financial instruments such as derivatives. As the economy becomes knowledge intensive and companies come out with complex financial products with hybrid features, there is a need for dynamic measurement concept to present true values of the resources available with an enterprise. Though there are many alternatives to historical cost model, standard setters around the world such as FASB (USA) and IASB have focused on the fair value concept. Proponents of fair value argue that fair values enhance transparency by making users aware of the true value of firms' net assets thus, measuring the true worth of the company. Fair Values are in line with the decision usefulness perspective of accounting standards which argue that market-based evaluation is more

[4]The Trueblood Report, Objectives of Financial Statements (1973)
[5]Financial Accounting Standards Board (FASB, Statement of Financial Accounting Concepts no.1: Objectives of financial reporting by business enterprises, FASB (1978)

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relevant to the investors as they help in better prediction of future cash flows and valuation of the firm.

2. **Substance over Form:** IFRS are principle-based standards unlike local GAAP of other countries. Principle Based Standards are those that lay emphasis on the substance of the transaction rather than legal form. Examples of application of this principle are IND-AS 32 (Financial Instruments) wherein Redeemable Preference Share Capital is treated as a Financial Liability; IND-AS 110 (Business Combination), IND-AS 27 (Separate and Consolidated Financial Statements) wherein the definition of control has changed from the bright line requirement of 50% voting power to a more conceptual one. Also, IND-AS 17 (Leasing) calls for operators to analyse arrangements to use specific assets and recognize them as lease even if the transaction is structured otherwise. The above illustrations showcase how IFRS are based on economic substance of the transaction and force managers and auditors to evaluate the true nature of the transaction before reporting resulting in more usefulness to the users (Ferring, 2004).
3. **Predictive Ability:** It is argued that earnings based on fair values have better predictive power as fair values are based on expected future cash flows. Earnings that are a product of fair value oriented system may better predict future cash flows and earnings (Bratten et al, 2016). Also, the book value of assets under IFRS measured at fair values represent future cash flow/earnings potential and hence, may improve the predictive ability. The twin features of IFRS: fair values and emphasis of substance over form provide relevant information for forecasting and hence, believed to have greater predictive ability than erstwhile AS.

Review of Literature

Value Relevance of BVPS and EPS

The value relevance of accounting figures prepared under German GAAP; US GAAP and International Accounting standards were compared by **Bartov et al (2005)** on dataset of 417 German firms reporting alternatively under these 3 standards. They found that returns under US GAAP and IAS were on an average lower that returns under German GAAP. They also found higher value relevance for firms reporting under these two regimes as compared to German GAAP. In comparing the value relevance of same set of firms switching from German GAAP to IAS/US GAAP, they found that switching to these two regimes improved the relation between earnings and returns.

Hung and Subramanyam (2007) conducted an analysis of 80 German firms that opted for IAS between 1998 and 2002. Their research revealed notable differences when comparing IAS to German GAAP. Specifically, they observed that total assets and total equity showed significant increases under IAS in contrast to German GAAP, and there was a greater variability in book values under IAS across different firms.

Goodwin et al (2008) studied a sample of 1065 firms in Australia to determine whether IFRS had any impact on accounting numbers and ratios and value relevance. They found that on an average, liabilities under IFRS increased and equity reduced, however, the changes were not significant. They also conducted value relevance tests on data for the same year measured

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alternatively under AGAAP and IFRS. The results did not show any significant difference in overall explanatory power of either of the models. They also found that results remain unchanged after controlling for firm size, industry and profit-loss firms.

Barth et al (2008) studied the accounting quality of 327 firms in 21 countries applying IAS voluntarilybetween 1994-2003. They did not find any significant difference in the VR of sample and control firms prior to adoption of IAS. Post-adoption, IAS firms' accounting figures were more value relevant. Since this study, the standards have undergone various changes and results cannot be applied in the IFRS regime.

Morais and Curto (2009) studied whether VR of IAS was higher than local European accounting standards using data of 6977 firms from 14 European countries. VR of IAS accounting figures was higher than local accounting standards for 10 out of 14 countries. They also compared the adjusted R-square for multiple models across different countries and found that value relevance was significantly higher in countries where accounting and tax regimes were not closely aligned, countries with weak law enforcement mechanism and countries where there existed wide divergence between local GAAP and IAS.

Agostino et al (2011) conducted a study on 221 listed banks in Europe employing data both before and after mandatory adoption of IFRS. Using data from 2000 to 2006, their results showed that both book value of equity and earnings were significant prior to IFRS. However, after implementation of IFRS, the significance of earnings increased but significance of book value of equity declined.

Clarkson et al (2011) compared the local GAAP and restated accounting figures for 3488 companies spread across EU and Australia for determining their VR. This study differs from other studies in the sense that it introduces a cross product term in the valuation model. They failed to find any difference in the value relevance of accounting figures using local GAAP and IFRS figures.

Garanina and Kormiltseva (2014) studied accounting information in 67 Russian listed companies that report under both local accounting standards (RAS) and IFRS for four consecutive years 2006-2009. They compare the differences between accounting figures prepared under each regime separately for 4 years and found significant difference in the Price to adjusted book value ratio only in 2007. They found no difference in VR under the two regimes.

Beisland and Knivsfla (2015) investigated the value relevance of accounting figures following the adoption of IFRS, incorporating two significant IFRS modifications: fair value measurement and heightened recognition of intangible assets, as explanatory factors. They employed price and returns as alternative dependent variables and concluded that fair value accounting enhances the value relevance of equity's book value.

Elbakry et al (2016) studied how IFRS impacted the VR of accounting data in Germany and U.K using modified Ohlson model. The authors employed Panel Cointegration with VECM citing the limitations in OLS models. They showed that in UK coefficient on book value per share increased significantly following shift to IFRS, while the coefficient of EPS remained

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insignificant both pre and post IFRS. The Coefficient of the error correction term increased after IFRS which shows that the long run granger causal association from accounting variables to equity returns has increased. In contrast, the Germany results showed that the coefficient of EPS increased significantly after switch to IFRS while that on BVPS remained insignificant.

Hillier et al (2016) employed a sample of 347 African firms and data from 2002-2009, and ran fixed effects panel regression on Ohlson model, using change in earnings as a proxy for "other information" and firm size, firm growth and leverage as control variables. They found that unlike most of the developed countries, book value coefficients were highly significant post IFRS while earnings coefficient became insignificant post IFRS. The findings remain unchanged after controlling for legal origin

Garcia et al (2017) analysed VR of 923 companies from 4 Latin American countries (Argentina, Brazil, Chile and Mexico) where IFRS is mandatory. They used total market capitalization as dependent variable and size, efficiency, risk, Asset Turnover, Growth in sales as control variables and employed Panel methodology. The results depicted that earnings were more relevant than equity under IFRS.

Outa et al (2017) used separate models pre and post convergence for comparing VR of key accounting figures. They used the data of 52 companies listed on Nairobi Securities Exchange from 2005- 2014. The authors employ Ohlson (1995) model with debt ratio, size and beta as control variables. Their findings confirm higher value relevance of figures under IND-AS as depicted by higher R^2 and increased coefficients of BVPS and NIPS.

Nijam and Jahfer (2018) did a similar exercise on firms in Srilanka. Using a sample of 188 listed companies from 2012 to 2014, the authors concluded that only book value of equity was relevant prior to IFRS but after IFRS both the accounting figures became relevant. The authors have employed plethora of models ranging from separate yearly cross-sectional regression to pooled regression models with dummy, but fail to explain the significance of employing several models simultaneously to capture the same phenomenon.

Chehade and Prochazka (2023) examined a sample of 98 listed firms of Saudi Arabia from 2014-2019 to compare the VR of accounting figures before and after IFRS. They discover that both earnings and cash flows are value relevant in the period before and after IFRS but equity was found only post IFRS.

Value Relevance of IAS/IFRS Reconciliations

Niskanen et al (2000) studied Finnish Local Accounting Standards and their reconciliation to IAS using a unique sample of 97 companies which had separately listed restricted and unrestricted shares meant for domestic and foreign investors respectively. They measured value relevance using returns-earnings regression. They found that for both domestic and foreign investors, net income under local Finnish GAAP was value relevant. An important contribution of this paper is that they provide evidence that foreign investors do not assign greater value to IAS earnings as anticipated by IASB. The same items were found value relevant to both

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categories of investors. This paper does not provide adequate explanation for employing pooled OLS methodology.

Tsalavoutas et al (2012) analysed the relevance of total book value and profits of 1861 firms belonging to Athens Stock Exchange across 8 years (2001-2008) before and after adoption of IFRS in 2005. Employing Ohlson's Price model, they also found that book value and earnings coefficient did not show any significant change post IFRS. Individual adjustments w.r.t specific standards were relevant.

Studies in India

Sharma et al (2012) conducted a study on 71 Indian companies listed on NSE to guage the value relevance of various income statement, balance sheet and cash flow statement indicators over time. They found that RONW and Profits are significantly related to P/B ratio. It is possible that it may be due to omitted variable bias and use of P/B ratio as dependent variable. Pooled and separate regression models present conflicting results so a more consistent and robust approach such Panel methodology should have been used.

Srinivasan and Narasimhan (2012) study the value relevance of consolidated earnings vis-à-vis to parent only earnings of 59 companies from financial years 2004-05 to 2007-08. They use a linear price to earnings model and use both standalone and consolidated earnings as explanatory variables. The found that only standalone earnings were value relevant and these results were robust to various specifications. In this study, both parents' earnings and consolidated earnings were introduced in the same model but there is a common component in them which may affect the results. It is possible that results could have been different had the two models been run separately.

Vardia et al (2016) used the data of 11 companies that adopted IFRS during 2011-2016 for their consolidated statements. They found book value of equity to be more relevant that earnings. Small sample size and unclear methodology restrict the use of results of this paper.

Srivastava and Muharam (2021) study the VR of EPS and BVPS under IFRS in two emerging economies: India and Indonesia. Taking the post implementation data of both the countries, the authors conclude that value relevance of EPS has increased. There are several conceptual and methodological issues in this paper. Firstly, IND-AS was implemented in India w.e.f 2016-17 with only few firms adopting voluntarily in 2015-16. The authors have taken sample period from 2015-16 which makes their results questionable. Secondly, using panel data methodology could have been more superior to running separate regression models for each year. Thirdly, there are many other factors that impact prices apart from earnings and book value which should also have been considered. The authors should have done a pre IFRS and post IFRS study to comment conclusively on the impact of IFRS on value relevance. Lastly, the price model suffers from scale issue so the author should also have taken returns as dependent variable.

Zavodny and Prochazka (2022) compared earnings, cash flows and equity in context of their value relevance in 4 European countries: Czech Republic, Hungary, Poland and Slovakia using data of 604 companies for the period: 2005-2017.

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Conclusion and Further Research

This study describes the theoretical foundation of value relevance studies particularly in the context of accounting research and introduction of IFRS. The literature in the field of value relevance research has been reviewed from 2005 till date. Since IFRS were mandatorily adopted in majority of the countries in 2005, we have reviewed the research in the field of impact of IFRS on value relevance of accounting numbers post that year.

We observed that there is no consensus amongst researchers on whether value relevance of specific accounting items has increased post IFRS. Also, most of the studies lack control variables and do not mention whether the research has been done on standalone or consolidated data. Most of the studies take only two to four years' data pre and post IFRS which, to our understanding, is very small time period to assess the value relevance of IFRS. It is possible that by increasing the sample size in terms of years, both before and after IFRS, more robust results may be obtained. We also observed that there is lack of research on value relevance of IFRS in developing countries like India and other South Asian countries which can be addressed by the future researchers.

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