



## THE IMPACT OF IFRS ADOPTION ON EQUITY VALUATION: AN EMPIRICAL ANALYSIS

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### ABSTRACT

*The study examines the impact of IFRS on market performance of the selected companies from the chemicals sector of the economy listed on the National Stock Exchange. Earnings Per Share, Price Earnings Ratio and Dividend Yield were selected as performance criterion. Data were collected and divided into pre and post IFRS-Comparative analysis and T test was done to ascertain influence of pre and post IFRS adoption on market performance of the companies. Findings indicate that differences on market performance between Pre and Post IFRS periods are not significant suggesting a weak correlation between adoption of IFRS and market performance of the selected companies.*

**KEYWORDS:** IFRS Adoption, Market Performance, Earnings Per Share, Price Earnings Ratio, Dividend Yield.

## **Introduction**

The increasing globalization of business, along with improvement in technology has led to the globalization of the capital market and increased foreign direct investment. Understanding the potential impact of IFRS on a company's accounting process is critical to accountants, auditors, corporate management, investors, lenders, financial analysts, regulators and others connected to corporate financial reporting. Studies of the effects of IFRS adoption so far mainly focus on its impact on the informational properties of Earnings for valuation purposes (Barth et al 2010; Daske et al 2010). The results of these studies indicate that IFRS adoption is associated with earnings becoming timelier, more volatile and more informative making their introduction beneficial for investors and shareholders. However, accounting statements are general purpose and are required to fulfill more than one role. Specifically, they are required to provide information for stewardship and contracting purpose as well as information that is value relevant. It is thus possible that an increase in value relevance could be achieved at the expense of decreased usefulness for these other purposes. An important difference between IFRS and GAAP is that IFRS place much greater reliance on the use of fair value and reported measures of earnings (Ernest and Young 2011.). Moreover, the move to Fair Value Accounting (FVA) makes accounting earnings figure more volatile. This increase in earnings volatility is likely to be driven by events almost entirely outside the control of management. This reduces the attractiveness of earnings for managerial performance based contracts because the signal to noise ratio of earnings for managerial performance declines (Dutta Kothari et al 2010). Due to the fair value approach that IFRS adopts, Watts (2008) and Shivakumar (2012) predict a decrease in the relative use of accounting earnings for rewarding and evaluating managers.

However, it is important to note that the primary objective of financial reporting based on IFRS is to provide high quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making (FASB, IASB). Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit and similar resources allocation decision enhancing overall market efficiency (IASB, 2008, IASB 2010). Although both the FASB and IASB stress the importance of high quality financial reporting, one of the key problems found in prior literature is how to operationalize and measure this quality. Because of its context-specification, an empirical assessment of

financial reporting quality inevitably includes preferences among a myriad of constituents. Since different user groups will have dissimilar preferences, perceived quality will deviate among constituents. In addition, the users within a user group may also perceive the usefulness of similar information differently given its context. As a result of this context and user specificity, measuring quality directly seems problematic (Botosan 2008). Consequently, many researchers measure the quality of financial reporting indirectly by focusing on attributes that are believed to influence quality of financial reports such as earnings management, financial restatements, and timeliness. Despite a considerable interest in the effectiveness of accounting standards on the quality of financial reporting, empirical literature emerged that offers contradictory findings about the questions to what extent accounting standards contributes to the decision usefulness of financial reporting information. In spite of the increased adoption of IFRS, most of the studies on the impact of IFRS on market performance that were recently conducted (Rees and Weigback 2002, Pownall and Schipper 1999, Hope et al 2006, Blanco and Osma 2008) were carried out in the developed countries. This highlights a major gap in the literature taking into account the differences that exist between developed and developing countries culturally and technologically. Hence this research work provides an understanding of IFRS and its impact on market performance in relation to Indian generally accepted accounting principles and also to investigate these differences in market performance of the selected companies Pre and Post IFRS adoption. Furthermore, It is possible that investors would react positively to movement towards IFRS adoption if, for example, they expect application of IFRS to result in higher quality financial reporting relative to application of domestic standards, thereby enhancing financial reporting transparency, reducing information asymmetry and information risk and thus lowering cost of capital. This prediction is supported by prior research. For example, Barth et al (2008) finds that application of International Accounting Standards (IAS), which comprises a large portion of IFRS, is associated with higher quality accounting amounts than application of domestic standards. Similarly, Karamanou and Nishiotis (2005), Diamond and Verrechia (2001), and Baiman and Verrechia (2000), Leuz and Verrechia (2001), and Barth et al (2007) among others find that higher financial reporting quality is associated with the adoption of IFRS and its impact on market performance.

The pivotal question now is (1) How different is market performance measured pre IFRS from performance measured post IFRS and (2) How much incremental information value if any is provided on Earnings Per Share, Price Earnings Ratio, Dividend Yield after the adoption of IFRS? No prior study has examined concurrently both differences and the impact on market performance. Hence the research will focus on the differences in market performance before and after the IFRS adoption under the Earnings per Share, Price Earnings Ratio and Dividend Yield and also to examine the incremental information value provided after the adoption of IFRS concurrently.

## **Literature Review**

### **Conceptual Framework**

The conceptual framework below is developed to investigate the relation between IFRS Adoption and company's market performance. In this conceptual framework, IFRS Adoption and market performance are the predictor and criterion variables. The present study therefore tries to cover the gap by providing a basis for good judgment of the effect of IFRS Adoption on market performance.

**Price Earnings ratio:** The most common measure of how expensive a stock is. The P/E ratio is equal to a Stock market capitalization divided by its after-tax earnings over a 12-month period, usually the trailing period but occasionally the current or forward period. The value is the same whether the calculation is done for the whole company or on a per-share basis. The higher the P/E ratio, the more the market is willing to pay for every unit of earnings. Companies with high P/E ratios are more likely to be considered "risky" investments than those with low P/E ratios, since a high P/E ratio signifies high expectations. Comparing P/E ratios is most valuable for companies within the same industry. The last year's price/earnings ratio (P/E ratio) would be actual, while current year and forward year price/earnings ratio (P/E ratio) would be estimates, but in each case, the "P" in the equation is the current price. Companies that are not currently don't have a P/E ratio at all.

**Dividend Yield:** Dividend yield is otherwise referred to as dividend-price ratio. It is the dividend per share divided by the price per share. It is calculated by a company's total annual dividend payments divided by capitalization, assuming the number of shares is constant and is often expressed in percentage. Dividend yield is used to calculate the earnings on investment (shares) considering only the returns in the form of total dividends declared by the company during the year.

**Earnings per Share:** Earnings per share refers to a portion of the earnings of a company allocated to each unit of outstanding shares. It is earnings divided by the number of ordinary shares held by the company at the end of the financial year. It is an indicator of profitability and is calculated by subtracting from net income dividend due to preferred stock holders the value obtained is then divided by the average number of shares.

### **Empirical Studies**

Studies of the effects of IFRS adoption so far mainly focus on its impact on the informational properties of earnings for valuation purposes (Barth et al 2010, Deske et al 2010). Ding et al (2006) investigated whether there is a change in market performance in US under the US GAAP period and the IFRS period. They found out that indeed there is a change in market performance in the IFRS period. The study by Rees and Weisbach (2004) indicates that greater investor protection associated with IFRS leads to improve Stock Price, Earnings Per Share,

Dividend Yield and Price Earnings Ratio. Hellman (2011) found a research opportunity created by Sweden's voluntary adoption of IFRS during 1991 – 2004. Empirical results of the study suggest that a soft adoption of IFRS in Sweden provided firms discretion that was used for share earnings purposes. Prior research by Barth (2008), Ball (2006) and Nobes (2006) evaluate the feasibility of convergence to IFRS, including the potential advantages of producing more accurate, timely and complete financial information, removing international differences in accounting standards and eliminating impediments to the global capital markets. However, Armstrong et al (2010) compare pre IFRS adoption data with post-IFRS adoption data on Earnings Per Share, Price Earnings Ratio and Dividend Yield and found that investors reaction to adopting firms was generally positive. Research by Byard et al (2010) found that analyst forecast errors and dispersions were lessened during the period of IFRS adoption in the developed countries with strong enforcement regimes. Another study determined that mandatory adoption of IFRS significantly lowers the cost of equity to domestic firms, however, this result was tempered by the countries legal enforcement strength (Li 2010). Taken together, these results lend support to the expectation that IFRS adoption reaps certain benefits.

## **Effects of IFRS on Earnings**

A number of studies investigate the financial reporting consequences of the adoption of IFRS. Barth et al. (2008) show that the voluntary adoption of IFRS is associated with less earnings management (i.e., less earnings smoothing), timelier loss recognition and higher value relevance of accounting earnings. As metrics for these earnings properties, the authors use, among others, the variability of the change in earnings, the ratio of the variability of the change in earnings to the variability of the change in cash flows and the recognition of large losses. Barth et al. (2008) claim that these characteristics suggest that accounting earnings are more informative (for valuation) and of higher quality, after the introduction of IFRS. Hung and Subramanyam (2007) reach similar conclusions about accounting quality for German voluntary adopters between 1998 and 2002. The results are mixed in similar studies of mandatory adopters of IFRS. Although Christensen et al. (2008) report similar results to Barth et al. (2008) for voluntary German IFRS adopters, they show that firms forced to adopt IFRS demonstrate no signs of accounting quality improvement. Similarly, Jeanjean and Stolowy (2008) find no indication of a decrease in earnings management for firms for which IFRS adoption was mandatory, in Australia, France and the UK. Alali and Foote (2012) report an increase in the value relevance of accounting figures after the mandatory adoption of IFRS in an emerging market. On the other hand, Horton and Serafeim (2010) study the reconciliation of accounting figures from the local Generally Accepted Accounting Principles (GAAP) to IFRS in the UK, where the adoption of IFRS was mandatory for all firms after 2005. They show that the market reacts to negative earnings adjustments due to IFRS reconciliations and also that positive (negative) adjustments are value-relevant, pre and post (only post) IFRS. These results strongly indicate that accounting earnings in the UK become more informative for valuation purposes, post-IFRS. Christensen et al. (2009) also show market reactions due to IFRS reconciliations and the new information they convey. However, they also find that the market reactions are more pronounced in firms that face debt covenant violations from earnings adjustments due to IFRS. These results suggest that the market reaction to IFRS adoption in the UK was driven, at least in part, by contractual considerations. However, they take the set of contracts as given, and do not consider the possibility that IFRS adoption may have led to changes in contracts because of the changes in the properties of accounting earnings driven by IFRS.

In an approach similar to this, Wu and Zhang (2009) study the consequences of voluntary implementation of IFRS from a stewardship perspective. They claim that, with earnings

being more informative after the introduction of IFRS, their role is expected to be more important in the firm's internal performance evaluation. More precisely, they show an increase in the sensitivities of CEO turnover and employee layoffs to earnings in the post-IFRS period, for their sample of voluntary adopters from ten European countries. However, Wu and Zhang (2009) do not take into account the fact that, as previously analyzed, even if earnings are more informative for valuation purposes, they are not necessarily more informative for stewardship purposes. Therefore, their ex-ante assumption of an increase in the use of earnings for internal performance evaluation post-IFRS appears weak. In addition, this study's empirical findings based on the investigation of the actual contracting changes contradict their assumption. Similar assumptions are used in two recent studies. Ozkan et al. (2012) examine how the mandatory IFRS introduction in continental Europe affects the use of accounting information for executive pay purposes. They show a weak increase in the Pay- Performance-Sensitivity (PPS) for accounting earnings for countries where the difference between local GAAP and IFRS is the greatest. They also report an increase in the use of Relative Performance Evaluation (RPE) with foreign peers, due to the increase in comparability post-IFRS. In addition, Ke et al. (2012) study how China's mandatory adoption of IFRS has affected the role of financial reporting information for contracting purposes. Contrary to the results of Ozkan et al. (2012) for EU countries, they show that for those Chinese firms that have been mostly affected by IFRS there is a significant decrease in the CEO's PPS for accounting earnings. They argue that in a weak investor protection country like China, the stewardship usefulness of accounting information post-IFRS has decreased.

Due to data unavailability for (non-UK) European and Chinese firms, all three aforementioned studies do not make use of the actual terms of the contractual agreements they examine, something that has been done in this study. As mentioned earlier, the adoption of fair value accounting makes post-IFRS earnings mechanically more related to market values. Given that market values drive the value of equity based compensation it is entirely plausible that one could observe higher PPS post-IFRS. Without though examining the actual contracting arrangements, i.e., actual use of accounting-based performance measures, we cannot draw any conclusions regarding the usefulness of earnings figures for managerial performance evaluation post-IFRS. Therefore, we believe that the above mentioned studies cannot establish whether the reported changes in PPS post-IFRS are due to a higher

emphasis placed on accounting earnings in the actual internal performance evaluations (i.e. pay contracts) or to the higher correlation between firm market value and reported earnings due to fair value accounting (confounding effect).

## **Methodology**

### **Data**

Financial statements of the sixteen selected companies of the chemicals sector of the economy listed on the National Stock Exchange from 2013 to 2017 were used for the study

### **Variabls**

#### **Independent Variable:**

The independent variable in this research is International Financial Reporting Standard (IFRS). The financial statements are divided into pre and post IFRS to measure the effect of reporting IFRS by comparing firms' performance between the two periods and then establishing if there is correlation between IFRS and firms' performance.

#### **Dependent Variable:**

##### **Market Performance**

Market performance is seen as the behaviour of a security or asset in the market place. (Lang et al 2003; Bartor et al 2001). Market performance is not tangible or seen, thus proxies will have to be developed. Such proxies of market performance include Earnings Per Share, Price Earnings Ratio and Dividend Yield.

Earnings per Share is calculated by dividing the company's profit after tax by the hinter of shares outstanding.

$$\text{EPS} = \frac{\text{PA}}{\text{T}}$$

Outstanding Share

Price Earnings ratio is calculated as: Market Value per Share / Earnings per Share

Dividend Yield = Annual Dividend Per Share / Price of Share

## Method

Descriptive statistics in the form of tables is used in the study to present relevant data computed from relevant annual financial statements of the firms under study. In addition, a comparative analysis (difference between groups) was applied by the researcher. The relationship between the independent and dependent proxies of market performance was determined using independent sample t-test. The statistical tool is represented by the following formulae.

$$t = \frac{(X_1 - X_2) - (U_1 - U_2)}{Sx_1 - x_2}$$

Where

X1 is mean for Pre – IFRS

X2 is mean for Post – IFRS

U1 and U2 are the true means (that Ho says are the same) and

S is the standard deviation.

## Findings

### Hypothesis 1

#### Comparison of Mean of EPS Pre- and Post-IFRS

##### Adoption.

One of the major areas investigated in this research is the comparison of Earnings per Share pre- and post-IFRS Adoption.

Ho1: There is no statistically significant difference between average levels of EPS pre- and post-IFRS period.

**Table 1: Descriptive Statistics of EPS in Pre- and Post-IFRS Periods.**

Group Statistics

	PERIOD	N	Mean	Std. Deviation	Std. Error Mean
EPS	PRE-IFRS ADOPTION	30	2.4353	4.69337	.85689
	POST-IFRS PERIOD	20	3.7845	8.02691	1.79487

(Group Statistics) shows descriptive statistics for the two groups (EPS pre- and post-IFRS period) separately. Note that the means for the two groups look somewhat different. This might be due to chance, so we will want to test this with the t test in the next table.

**Table 2: Comparison of EPS Values Pre- and Post-IFRS Independent Samples Test**

	Levene's Test for Equality of Variances		t-test for Equality of Means		
	F	Df	T	Df	Sig. (2-tailed)
EPS Equal variances assumed	1.346	.252	-.750	48	.457
ESP Equal variances not Assumed			-.678	27.7005	.503

Source: SPSS version 20 Output, Computed from table data 2013-2017.

Table 2 (Independent Samples Test) provides two statistical tests. In the left two columns of numbers, is the Levene's Test for Equality of Variances for the assumption that the variances of the two groups are equal (i.e., assumption of homogeneity of variance). Note that this is not the t test; it only assesses an assumption! If this F test is not significant (as in the case), the assumption is not violated (that is, the assumption is met), and one uses the Equal variances assumed line for the t test and related statistics. However, if Levene's F is statistically significant (i.e. if Sig.,  $p < .05$ ), then variances are significantly different and the assumption of equal variances is violated (not met). In that case, the Equal

variances not assumed line would be used – for which SPSS adjusts the t, df, and Sig. as appropriate. Also in the second table we obtain the needed information to test the equality of the means. Also recall that there are two methods in which we can make this determination.

Method One (most commonly used): comparing the Sig. (probability) value ( $p = .457$ ) to the  $\alpha$  priori alpha level ( $\alpha = .05$ ). If  $p < \alpha$  – we reject the null hypothesis of no difference. If  $p > \alpha$  – we retain the null hypothesis of no difference. For this study,  $p > \alpha$ , therefore we accept the null hypothesis and conclude that the post-IFRS group ( $M = 3.7845$ ) EPS is insignificantly more than the pre-IFRS group ( $M = 2.4353$ ) EPS.

Method Two: comparing the obtained t statistic value ( $t_{obt} = -.750$ ) to the t critical value ( $t_{cv}$ ). Knowing that we are using a two-tailed (non-directional) t test, with an alpha level of  $.05$  ( $\alpha = .05$ ), with  $df = 48$ , and looking at the Student’s t Distribution Table – we find the critical value for this study to be  $1.960$ . If  $|t_{obt}| > |t_{cv}|$  – we reject the null hypothesis of no difference. If  $|t_{obt}| < |t_{cv}|$  – we retain the null hypothesis of no difference. For this study,  $t_{obt} = -.750$  and  $t_{cv} = 1.960$ , therefore,  $t_{obt} < t_{cv}$  – so we retain the null hypothesis and conclude that there is a statistically insignificant difference between the two groups. More specifically, looking at the group means, we conclude that the post-IFRS group ( $M = 3.7845$ ) EPS is insignificantly more than the pre-IFRS group ( $M = 2.4353$ ).

## Hypothesis 2

Ho2: There is no statistically significant difference between average levels of P/E Ratio in the post-IFRS period compared to the pre-IFRS period.

**Table 3: Descriptive Statistics of P/E Ratio in Pre- and Post-IFRS Periods.**

Group Statistics

	PERIOD	N	Mean	Std. Deviation	Std. Error Mean
P/E Ratio	PRE-IFRS ADOPTION	30	10.7257	16.68516	3.04628
	POST-IFRS PERIOD	20	12.6065	12.65445	2.82962

(Group Statistics) shows descriptive statistics for the two groups (P/E.R pre- and post- IFRS period) separately. Note that the means for the two groups look somewhat different. This might be due to chance, so we will want to test this with the t test in the next table.

**Table : 4 Comparison of P/E Ratio Pre- and Post-IFRS**

**Independent Samples Test**

		Levene's Test for Equality of Variances		t-test for Equality of Means		
		F	Sig.	T	Df	Sig. (2-tailed)
P/E RATIO	Equal variances assumed	.010	.919	-.428	48	.670
	Equal variances not assumed			-.452	47.107	.653

Source: SPSS version 20 Output, Computed from table data 2013-2017.

Comparing the Sig. (probability) value ( $p = .670$ ) to the  $\alpha$  priori, alpha level ( $\alpha = .05$ ). If  $p < \alpha$  – we reject the null hypothesis of no difference. If  $p > \alpha$  – we retain the null hypothesis of no difference. For this study,  $p > \alpha$ , therefore we retain the null hypothesis and conclude that the post-IFRS group ( $M = 12.6065$ ) P/E RATIO is insignificantly more than the pre-IFRS group ( $M = 10.7257$ ) P/E RATIO.

**Hypothesis 3**

H03: There is no statistically significant difference between average levels of Dividend Yield in the post-IFRS period compared to the pre-IFRS period.

**Table : 5 Descriptive Statistics of Dividend Yield in Pre- and Post-IFRS Periods.**

Group Statistics

	PERIOD	N	Mean	Std. Deviation	Std. Error Mean
Dividend	PRE-IFRS ADOPTION	30	.7360	.68725	.12547

Yield	POST-IFRS PERIOD	20	1.6805	4.02346	.89967
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Table 5 (Group Statistics) shows descriptive statistics for the two groups (Dividend Yields pre- and post-IFRS period) separately. Note that the means for the two groups look somewhat different. This might be due to chance, so we will want to test this with the t test in the next table.

**Table : 6 Comparison of Dividend Yield Pre- and Post-IFRS**

Independent Samples Test

		Levene's Test for Equality of Variances		t-test for Equality of Means		
		F	Sig.	t	Df	Sig. (2-tailed)
DIVIDEND YIELD	Equal variances assumed	3.365	.073	-1.265	48	.212
	Equal variances not assumed		.311	-1.040	19.741	.311

Source: SPSS version 20 Output, Computed from table data 2013-2017.

Comparing the p-value ( $p = .670$ ) to the  $\alpha$  priori, alpha level ( $\alpha = .05$ ). If  $p < \alpha$  – we reject the null hypothesis of no difference. If  $p > \alpha$  – we retain the null hypothesis of no difference. For the third hypothesis,  $p > \alpha$ , therefore we accept the null hypothesis and conclude that the post-IFRS group ( $M = 1.6805$ ) Dividend Yield is insignificantly more than the pre-IFRS group ( $M = 0.7360$ ) Dividend Yield.

## Discussion

Using an alpha level of .05, an independent-samples t test was conducted to evaluate whether the average percentage of market performance of the selected companies differed significantly as a function of whether financial statements were prepared in a pre- or post-IFRS period. The test was insignificant.

As a way of giving details about the findings of this study we discuss it below. In order to investigate the central research question three hypotheses were put together. The three hypotheses and the key findings of their tests are summarized below. The overall results

affirm that IFRS adoption has not significantly changed market performance. The investigation showed that:

### **Market Performance and its Attributes**

1. The level of EPS in the post-IFRS period is not more than the level of EPS in the pre-IFRS period.
2. The level of P/E Ratio in the post-IFRS period is not more than the level of P/E Ratio in the pre-IFRS period.
3. The level of Dividend Yield in the post-IFRS period is not more than the level of Dividend Yield in the pre-IFRS period.

### **Implication To Research And Practice**

The results of this research confirm that the adoption of IFRS does not automatically translate to higher market performance. This is in contrast to Barth et al (2008) which finds that firms' performance is enhanced by adoption of IFRS. Also, for policy makers, practitioners and academicians it provides a platform to explain or understand the efficacy of IFRS adoption and the impact of IFRS adoption on the market performance of the selected companies.

### **Conclusion**

The purpose of the research was to examine the impact of IFRS on market performance of the selected companies from the chemicals sector of the economy listed on the National Stock Exchange. Findings of the study support the view that differences between IFRS and GAAP are not significant, thus, supporting proponents of adoption of IFRS. The research examined whether key indicators of market performance post-IFRS are significantly different from pre-IFRS period. The first research question addressed is: Is there statistically significant difference between average levels of Earnings per Share in the post-IFRS period compared to the pre-IFRS period? Results show a lack of significant differences between IFRS- and GAAP-reported financial statements' EPS. This shows that there is substantial convergence between IFRS and GAAP. The second research question examined is: Has P/E Ratio declined since the adoption of IFRS? Results indicate that investors do not give a market premium to those firms that adopt IFRS. This is also an

important finding, as it affirms the view that the accounting quality and/or disclosure levels under IFRS are relatively equal to GAAP. The third research question examined is: Is the difference in Dividend Yield significant in the IFRS period? The result showed that there is no statistically significant difference between dividend yield in the IFRS period and the pre-IFRS period.

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