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INCOME SMOOTHING AND TRANSPARENCY OF FINANCIAL STATEMENTS: EVIDENCE FROM LONDON STOCK EXCHANGE

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ABSTRACT

This study seeks to determine the transparency of financial statements information under IFRS of the companies registered on the London stock exchange. In this regard, annual data of financial statement information of companies registered on London Stock exchange is taken for the duration 2015 to 2020. Earnings management and value relevance are taken as a proxy for the transparency of financial accounting quality. In this study, the share price has been used as a dependent variable and the independent variables were net income per share and book value of equity per share. The regression model and Hausman test were applied and the findings of the regression model depict that the financial statement information of the companies registered on LSE produced under the IFRS is transparent and value relevant. Moreover, the results indicate that the accounting information produced under the IFRS has less scope of earnings management as compared to GAAP.

Keywords: Accounting Quality, Earnings Management, Financial Statements, IFRS, London Stock Exchange
JEL Codes: H83, N2

I. INTRODUCTION

The transparency of the financial statements has become very important in this modern era because it shows the financial health of the organizations. The investors believe that the financial statements of the firms show the real picture of organizations and they use these financial statements to evaluate the worth and share prices. The financial reporting is considered as important tool of information through which the investors estimate the value of the share. In this regard, the IFRS and GAAP are used all over the world. Recently, the adoption of IFRS has made many changes in the accounting standards. Most of the European countries and UK have shifted toward the IFRS. The Financial Accounting Standards Board has mentioned that an accounting system provides the useful information to the investors. Many researchers have discussed the IFRS in the code law and the common law countries (Jermakowicz et al., 2006; Paananen and Parmar, 2008; Yip and Young, 2012). According to (IFRS, IASplus.com): "To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information make economic decisions" Moreover, recent financial crises, accounting scandals and subsequent regulations like Sarbanes Oxley act 2002, stress the need for transparency in the financial information. The point is whether the two leading accounting standards are able to meet their own demand of transparency? How can we check that the financial information generated by these standards are transparent? For answering this question, we have to objectively define the domain or ingredients of transparency of financial information and how we can measure it. This motivates us to study and examine the above mentioned attributes of the financial statements under both the standards.

The main objective of IFRS and the convergence projects between the IFRS and US GAAP is to increase the comparability and transparency of financial statements information. Therefore, this study tends to check the transparency of financial statements information under IFRS of the companies listed on the London stock exchange. This study generates interesting implications with respect to the convergence projects between the IFRS & US GAAP.

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Moreover, the specific country factors such as common law or code law country can also be examined in one to one analysis. The study is fruitful for the investors, govt. authorities, researchers, accountants and international institutions. The rest of the research paper is comprised as follows: literature review have been discussed in part 2, methodology portion has been given in part 3, the empirical results have been mentioned in part 4 and the final part shows the conclusion of the study.

II. LITERATURE REVIEW

Extensive literature have been available on the transparency and quality of the financial statement information in different regions of the world (Ball et al., 2000; Bartov et al., 2005; Callao et al., 2007; Paananen and Lin, 2009). When we say that the financial statements are transparent, we can imply from this proposition that financial statements represent true and fair view and when there is true and fair representation of the financial position of the firm then it means there is no room for the earning manipulation or income smoothing. Similarly, it also can be conceived that the since accounting information or indicators are transparent, they reflect the economic reality of the firm for which the share price is other proxy(Brian Singleton-Green, 2014). In literature, we also discuss the earning management and value relevance in context of accounting quality(Barth et al., 2008). So, following this lead, we can deduce that increasing the transparency of the financial statements enhances the accounting quality as well. Thus, transparency refers to the broader concept of which accounting quality is one subset. When we are discussing transparency, three major areas of research are regarded as providing evidence on the transparency of financial reporting. (Brian Singleton-Green, 2014)

1- Investment analyst forecast
2- Value relevance
3- Earnings Management

Due to the data limitation on the investment analysts forecast, we have focused on the value relevance and Earnings Management. These two proxies have also been focused in the literature for various countries, in different time periods and settings. Literature is overwhelmed by the studies for checking the impact of the IFRS adoption on the value relevance and Earnings management with mixed findings. Though, majority of the studies have a consensus that IFRS adoption had a positive impact in terms of increased value relevance and accounting quality but there are contra studies as well. (Clarkson et al., 2011), after controlling for the nonlinear effects, found no significant difference in the value relevance of earnings and book value of equity in both code and common law countries but overall we can say that literature has found more positive impact of IFRS than its cons. One thing common about these studies is this these all are discussing the impact of IFRS adoption, an event.

This is precisely one of the reason we choose the time period 2015 to 2020 in order to avoid another “Event study before and after IFRS adoption”. Moreover, in most of the countries, IFRS has been adopted now and their accounting structure has also been settled after adopting the new standard. So, now is a good time to check whether this standard has really brought a positive change in terms of increased value relevance and reduced earning management. Right now, there is just the one competitor for IFRS, US GAAP and regulators are also trying to converge and reduce the differences, these two standards pose because by nature these two are different set of standards and present different challenges and opportunities to not only managers and investors for decision making but also to academicians for the research (Barth, 2008). USA is only significant country practicing US GAAP while majority of the remaining world has accepted or accepting the IFRS. This presents a perfect platform to asses and see whether which one of these two is more practical and beneficial to its users. Which one is more transparent and which one can serve the purpose better than another in terms of preventing accounting fraud and making better financial decisions and limit the scope of discretionary smoothing.

Barth et al., (2008) in their detailed study of 21 countries came out with this result that implementation of IAS do serve well as compared to the domestic standards. Countries adopting IAS generally evidence less earnings management, more timely loss recognition, and more value relevance of accounting amounts. Iatridis (2010) echoes same arguments for his analysis for the UK firms when they switched from the UK GAAP to IFRS. The similar findings were also echoed in another (Barth, Landsman, Lang, & Williams, 2012) article that point out that though adoption of IAS has reduced the comparability differences between US GAAP and IAS but still work as to be done. Moreover, US GAAP is more value relevant with respect to net income and book value of equity but this analysis was between US firms adopting US GAAP and non US firms adopting IAS. Armstrong et al., (2010) investigated the equity market reaction to sixteen events associated with the adoption of IFRS in Europe and suggested that pros of IFRS adoption in Europe outweighs its cons in terms of increased information quality and decrease in information

asymmetry. However, these pros were less obvious in code law countries where investors feared the non-enforcement of the accounting standard will minimize the positive impact of IFRS adoption. In a direct comparison of US GAAP with the IFRS, Lin, Riccardi and Wang (2012), for the case of German high tech firms, found firms using US GAAP to be more value relevant, subject to less earning management and more time loss recognition as compared to the firms using IFRS. The same comparison done for German new market firms by (Van der et al., 2007) signifies that quality of US GAAP prepared financial statements and IFRS information is overall very comparable. Only with regard to predictive ability of accounting information do they found US GAAP superiority. In crux, there is lot of comparison done between the US GAAP & IFRS but the literature is being dominated by the event studies to check the impact of IFRS adoption and then comparing the results with the local or US GAAP. In this regard, we take the new data set and enables to investigate the quality and transparency of accounting information when IFRS has been fully endorsed by the sample countries and then comparing it with the US GAAP. Value relevance is broadly referred as the association between the earnings and book value of equity with the share price. Firms with higher accounting quality have a higher association between stock prices and earnings and equity book value because higher quality earnings better reflect a firm's underlying economics (Barth et al., 2008; Ali et al., 2021; Alim et al., 2021; Audi et al., 2021).

III. DATA AND METHODOLOGY

Value relevance and income smoothing have been thoroughly examined at the international scope (Brian Singleton, reviews more than 100 empirical studies that considers the impact of adoption of IFRS on value relevance, earning management, comparability, cost of capital, cost of debt and many other attributes, but all these studies are predominantly EU focused), but still one observes the dearth of research in using these conceptions under the framework of transparency. Value relevance and income smoothing have also been modeled for many single countries and recently there is a trend to measure these under the head of accounting quality for emerging markets However, literature is evolving in terms of incremental contribution to model these in context of transparency of financial statement. The data have been gathered from 2015 to 2020 from Thompson and Reuters Eikon Data Stream Value relevance in this study is measured by regressing the share price and return on share on net income, change in net income & book value of equity. We have used two metrics to measure the value relevance. Details regarding the independent & dependent variables and model for the first metric is as follows.
Dependent variables; Share Price (SP),
Independent variables; Net Income per share (NI); Book value of equity per share (BVE)
To ensure that the accounting information is incorporated in the share price and is in the public domain, P is the stock price six month after the fiscal year end (Barth et al., 2008)

$$sp = B^0 + B_1 NI + B_2 BvE + \varepsilon_0$$

We can interpret higher explanatory power among them as evidence of more value relevance

III.I. SECOND METRIC TO MEASURE THE VALUE RELEVANCE

It is to regress the change in NI along with the BVE on the stock return.
Return is calculated as the cumulative percentage change in stock price beginning nine months before fiscal year end and ending three months after fiscal year end. (Barth et al. 2012)

- ΔNI per share
- NI
- BVE

$$SR = B_0 + B_1 \Delta NI + B_2 NI + B_3 BvE + \varepsilon_0$$

III.II. INCOME SMOOTHING/EARNING MANAGEMENT

Following the lead of the argument presented above (higher the transparency lesser will be the room for income smoothing), the proxies that have been used in the literature as well for detecting the extent of income smoothing or earning manipulation are:

- Variance of change in net income
- Ratio of variance of change in NI and variance of change in cash flows
- Correlation between accruals and cash flows

Since, NI and Cash flows are not only effected by the choice of accounting standard, there are also so many other confounding factors that can have an impact on these independent variables. Some of these factors that affect the association of the share prices and earnings are listed below.

- Size = natural logarithm of end of year market value of equity;
- GROWTH = percentage change in sales;

- Δ SP = percentage change in common stock price;
- Leverage (LEV) = end of year total liabilities divided by end of year equity book Value
- Δ TL= percentage change in total liabilities;
- Turnover = sales divided by end of year total assets;
- CF = annual net cash flow from operating activities divided by end of year total assets;

III.III. EVIDENCE OF LESS EM

If

1- Variance of change in NI is higher
2- Ratio of variance of change in NI to variance of change in CF is higher
3- Less negative correlation between CFs and accruals.
4- Less frequency of small positive NI

IV. EMPIRICAL RESULTS

Top 25 companies (excluding the financial institutions) with respect to market capitalization of LSE for the time period 2015 to 2020. These 25 companies from the LSE have been chosen after applying various filters. For each firm, their share price, net income, BVE & EQ score has been taken from the Thompson and Reuters Eikon database and after accounting for the missing data and outliers, we have 125 annual observations in total. Summary statistics are below:

Table 1: Descriptive Statistics

Variables	Obs	Mean	S.D	Min	Max
SPGB	125	7.719	9.108	0.204	46.16
EQ	125	51.427	28.58	2	100
NI	125	203.79	717.31	-266	6444.89
BE	125	1669.8	3886.66	9.05	15809.18

From the results, we can interpret that model is significant. P value is less than 5%. F statistics is good, also indicates the better fit of our predictor variables. NI and EQ are significant and help explain the share price in the model whereas BVE is insignificant. Agostino et al (2011) also find insignificant BVE but his analysis was mainly for the banking sector of the EU.

Table 2: Results of Random Fixed Effects

Fixed Effects (Regression)				No. of Obs.		124
Group Variable ID				No. of Groups		25
R-Square	Within	0.1961		Obs. Per Group	Min	4
	Between	0.6120			Avg	5.0
	Overall	0.5719			Max	5
				Prob <F		0.001
SPGB	Coef.	Std. Error	t	P>t	95% conf.	Interval
EQ	0.0307	.0119	2.57	0.012	0.0069	0.0544
NI	-0.0335	.00899	-3.74	0.000	-0.0051	-0.0015
BVE	0.0021	.0014	1.47	0.146	-0.0007	0.0049
cons	3.297	2.311	1.43	0.157	-1.291	7.886
Sigma _u	5.4882					
Sigma _e	2.8638					
Rho	0.7859	Fraction of Variance				
F test that all u_i=0			F(24,96)= 15.45		Prob> F 0.000	

In order to determine which model will be a better fit i.e. fixed effect or Random effect, we have employed Hausman test whose null hypothesis is that random effect is more appropriate model. The result of the Hausman test is displayed below from which we can see that the P value is less than 0.05 which lead to the rejection of the null hypothesis i.e. Fixed effect is more appropriate model to capture the effects of predictor variables.

Table 3: Hausman Test

	Coefficients			
	b(re)	B(re)	(b-B) Difference	S.E
EQ	0.03073	0.03447	-0.0037	
NI	-0.00335	-0.0029	-0.0004	0.00059
BE	0.0021	0.0021	-0.00045	0.001414

b= consistent under H0
B= inconsistent under Ha
Test : H0: difference in coefficients not systematic
Prob>chi2 = 0.000

V. CONCLUSION

To detect the income smoothing, net income and change in net income has been regressed along with the Book value of equity and Earnings quality metric on share prices of the firms registered on the London stock exchange. The results and findings dictate that the accounting information produced under the IFRS is subject to less income smoothing and the earnings are value relevant in the case of London stock exchange. Lesser income smoothing is a proxy for the accounting quality which is evident in this case. Moreover, the significance of earnings also dictate that the share prices of the LSE companies are sensitive to the change in earnings which makes earnings management hard to go unnoticed. Despite this, there is still a need for the standardized framework which would help detect income smoothing all across the globe whether the accounting information is produced under the IFRS or GAAP. Though equity has been found insignificant in this short sample, but still we can say from this that investors or market prefer short time statistics such as net income and current state of the company. The results are expected to be more insightful while taking into account all the companies and since the sector wise data is available, so we can also do the inter sector comparison and know which sector is more value relevant.

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