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IFRS 7 disclosure and firms' beta: Evidence from South Africa

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Abstract

The ongoing financial crisis has highlighted the need for effective disclosure of financial information to aid the investor decision making process. One area of financial reporting that has received considerable attention is disclosure required in terms of IFRS 7 largely due to the standard's broad applicability and risk-orientated focus. This research considers the IFRS 7 disclosures of 28 South African listed companies for the four years, starting from 2008 to 2011, to determine if companies are better complying with the requirements of the IFRS and whether or not compliance with IFRS 7 is correlated with beta. The research finds that although companies are disclosing more financial risk related information, this is not necessarily translating into meaningful information for users, reemphasising the need for preparers to carefully consider how to better structure financial reports to enhance their utility.

Key Words

Beta	Compliance	Corporate governance
Financial reporting	JSE	IFRS 7
Risk-based disclosure	South Africa	Useful information

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Abstract

The ongoing financial crisis has highlighted the need for effective disclosure of financial information to aid the investor decision making process. One area of financial reporting that has received considerable attention is the disclosure required in terms of IFRS 7 largely due to the standard's broad applicability and risk-orientated focus. This research considers the IFRS 7 disclosures of 29 South African listed companies for the four years, 2008 to 2011, to determine if companies are enhancing their compliance with the requirements of the IFRS and whether or not compliance with IFRS 7 is correlated with beta. The research finds that although companies are disclosing more financial risk related information, this is not necessarily translating into meaningful information for users, reemphasising the need for preparers to carefully consider how to better structure financial reports to enhance their utility.

1: Introduction

Under the lens of agency theory, sound financial reporting has an important role to play in addressing information asymmetries between principals and agents (Watts and Zimmerman, 1978; Barth, 2008). This is especially true in the aftermath of the global financial crisis which has heightened the need for high quality reporting by companies, including a comprehensive focus on the identification and management of key business risks (Institute of Directors in Southern Afirca [IOD], 2009; International Integrated Reporting Commitee [IIRC], 2011; Integrated Reporting Committee of South Africa [IRC], 2011). By providing financial statements mindful of the information needs of users (International Accounting Standards Board [IASB], 2010b), financial reporting has the ability to improve investment decision-making and secure the legitimacy of the capital market system (Solomon, 2010; Canada, Khun and Sutton 2008; Unerman and O'Dwyer, 2004; IASB, 2010a; IRC, 2011; IOD, 2009). In particular, financial reporting concentrating on the identification of financial-based risks and associated mitigation strategies would be expected to lower estimation uncertainty while simultaneously enhancing organisational transparency (Botosan, 2006). Related to this, by reducing information asymmetries, added disclosure may prompt investors to reassess risk levels and amass larger

shareholdings leading to higher share prices and, by inference, reduced firm betas (Diamond and Verrecchia, 1991).

In this context, this research considers whether or not the beta of the top forty firms listed on the Johannesburg Securities Exchange (JSE) is inversely related to the extent of IFRS 7 disclosure. IFRS 7 is concentrated on due to its broad applicability, being relevant even for organisations that are not financial institutions (IASB, 2010a). Its focus on the identification of financial-instrument based risks and mitigation strategies also resonates with the calls for more integrated reporting that demonstrates the relationship between financial metrics, non-financial information, risk-levels and organisational sustainability (IRC, 2011: IIRC, 2011). As such, by considering the relationship between the extent of IFRS 7 disclosures and the beta of the top forty firms listed on the JSE, this study provides one of the first accounts on the extent of compliance with IFRS 7 and the association between IFRS 7 disclosures and systematic risk levels. In doing so, the paper adds to the existing body of accounting research that has concentrated mainly on financial reporting in traditional Anglo Saxon contexts, providing an account of the role of IFRS disclosures in Africa's leading economy (Brennan and Solomon, 2008; Botosan, 2006). Finally, the research sheds light on the quality of South African financial reports at a time when the country is embarked on a transition to more integrated reporting purportedly aimed at enhancing corporate transparency and improving investment decision-making (IRC, 2011).

2: Literature review

Agency theory predicts that a divergence of interests between principals and their duly appointed agents leads to a loss of firm value necessitating the use of a system of checks and balances to mitigate these residual losses (Jensen and Meckling, 1976). One example is the use of incentive schemes to align the interests of managers with those of shareholders (Hill and Jones, 1992; Drury, 2005). Contractual provisions that clearly define the nature and scope of the agent's duties are another (Coase, 1937; Jensen and Meckling, 1976). More broadly, corporate governance itself may be thought of as part of the process of managing the risk that agents, driven by the need to maximise their own utility, ultimately act in a manner that detract from the interests of multiple stakeholder groups (Solomon, 2010). Accordingly this calls for, *inter alia,* improved shareholder activism (Edward and Evan, 1990; Solomon, 2009); the need for independent board structures (IOD, 2009); regulation of corporate activities (Nel, 2001; Konar et al, 2003); and demands for high quality external audit (Watts and Zimmerman, 1983; Francis, 2004) are interconnected with the need to address agency problems in the context of imperfect information between stakeholders and agents.

In this context, sound financial reporting constitutes an important element of the corporate governance system, designed to mitigate agency costs and, in particular, address the issue of information asymmetries between managers and shareholders. In this light, the IASB (2010b) maintains that the ultimate objective of financial reporting is to:

> 'provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit' (IASB, 2010b, OB 2).

The use of IFRS has been championed on the grounds of providing consistent decision useful information concerning firm performance which has the potential to lower the cost of capital (Barth, 2008; IASB, 2010b). At the same time, high quality financial reporting standards would lower the costs of preparing financial statements simultaneously reducing the costs incurred by users in interpreting financial statements prepared in multiple jurisdictions, each based on local generally accepted accounting principles (Barth, 2008).

Given changing risk environments, the need to provide high quality decision-useful information is made all the more important. In response to changes in the corporate landscape, the financial reporting community has frequently revised existing standards or introduced additional guidance aimed at improving the quality of information made available to different stakeholder groups (Shaked and Sutton, 1981; IASB, 2010c). In doing so, information asymmetries giving rise to agency based costs, including those associated with moral hazard and adverse selection, are reduced. Improved financial reporting could allow firms to better communicate the performance and financial position of their operations, as well as associated risks, lowering the cost of raising finance and reducing adverse selection when it comes to the issuance of securities (Barth, 2008; Biddle and Hilary, 2006; Bushman and Smith, 2001; Schredelseker, 2001). As such, Biddle, Hilary and Rodrigo (2009) find that higher quality financial reporting is associated with lower levels of over- or under- investment, signalling improved investment efficiency. Similarly, in the absence of perfect information (Dietrich, Kachelmeier, Kleinmuntz and Linsmeier, 2001), using an experimental method, find that explicit disclosures can lead to improved market reactions, even when the relevant information could have been inferred from the financial statements. This benefit is accentuated when firms disclose both positive and negative facts and circumstances (see also IRC, 2011; IOD, 2009). In summary, the prior literature points to investors preferring securities with lower information asymmetry and estimation risks. As demand for these instruments is greater, they tend to command a superior price to alternate investments and, thus, a lower cost of capital (or beta). With added disclosure able to mitigate estimation risk and information asymmetry, it follows that a negative relationship should hold between the extent of IFRS disclosures and the respective firm's beta (Botosan, 2006).

From a slightly different perspective, Gwilliam, Macve and Meeks (2000) provide a case study on audit and accounting reform taking place at Lloyd's of London. The researchers document how structural changes in the insurance industry taking place during the 1970's and 1980's made it difficult for providers of collateral to monitor and assess the decisions of those responsible for the management of insurance risk and associated returns. Despite agency theory predicting the development of more rigorous monitoring arrangements as the 'information distance' between agents and principals grow, institutional characteristics of the United Kingdom's insurance markets frustrated this process. While external regulation, rather than market forces alone, culminates in a revision of related accounting practices, the same relationship between enhanced financial reporting and a perceived reduction in risk levels continues to hold. This is fully consistent with the more recent statements of the IRC (2011) and IIRC (2011) which have stressed how the current global financial crisis has accentuated the need for more holistic, balanced reporting by companies which, by default, necessitates the provision of high quality financial information.

Of particular, importance for the purpose of this research is the relevance of disclosures required in terms of IFRS 7. The 1990s saw the need to revise existing accounting practices dealing with disclosure in the financial statements of financial institutions. Changes in the manner in which banks and similar organisations were managing their core activities, including risk exposures, necessitated more comprehensive risk-based disclosure (IASB, 2010a; PwC, 2012). In this context IFRS 7 was issued in August 2005. The proliferation of financial instruments, however, meant that - in addition to bolstering the related disclosure requirements – the scope of the accounting standard was expanded (IASB, 2010a; PwC, 2012). Rather than deal with the financial sector alone, IFRS 7 applies to any organisation with financial instruments (Condon, 2008; IASB, 2010c). Its objective is to provide disclosures that will enable users to evaluate the significance of financial instruments for an organisation's financial position and performance and the nature and extent of the associated risks, including how the organisation manages those risks (IASB, 2010c). In October 2008, the IASB published an exposure draft with an aim to enhancing disclosures about fair value and liquidity risks. The amendments were issued during March 2009. In each instance, changes in accounting requirements speak to the need for enhanced disclosure and a heightened sense of transparency regarding organisational risk exposure and management (Condon, 2008; IASB, 2010c; IASB, 2010a). In this context, this research tests the following hypotheses:

H1: There has been an increase in IFRS 7 disclosures from 2008 to 2011 by the top 40 JSE listed companies.

H2: The greater the extent of IFRS 7 disclosure over this period, the lower the respective company's beta

The continuing global financial crisis heightening the relevance of adequate risk disclosure together with the increased focus on the compliance with accounting and governance standards, implies that the top 40 JSE listed companies would be improving the extent of IFRS 7-required disclosures. In turn, as financial reporting quality - in this instance measured by reference to the extent of disclosure in terms of IFRS 7 - improves, more useful information is made available to investors (see Barth, 2008; Biddle and Hilary, 2006; Bushman and Smith, 2001; Schredelseker, 2001). As such the respective firm's beta, serving as a measure of systematic risk, would lower, signalling a reduction in perceived risk levels. This may be especially true given the focus of IFRS 7 on the identification and disclosure of risks linked to financial instruments, and related risk management strategies. An alternate view is that an increase in disclosure under IFRS 7 may not necessarily provide significant decision useful information. Gao (2010), for example, theorise that cost of capital may increase with disclosure quality when new investments are elastic. Further, it may not always be the case that the cost of capital or organisation beta totally captures the effect of additional disclosure (Gao, 2010; Botosan, 2006). Related to this, compliance with IFRS 7 – including added disclosure of respective risks – may not necessarily significantly improve the usefulness of financial information if this is not intergraded with relevant non-financial disclosures (consider IRC, 2011; IOD, 2009; Solomon, 2010). As such, whether or not additional disclosure benefits firms by lowering their beta or cost of capital remains a contentious issue (Botosan, 2006). This is especially true in an African context given the lack of direct corporate governance research (Brennan and Solomon, 2008).

3: Method

A financial instrument disclosure checklist (the checklist) developed by the researchers using only the provisions of IFRS 7, including IFRS cross-referenced to by IFRS 7, serves as the data collection instrument. This automatically ensures a high level of content validity, being a measure of whether or not the instrument measures the phenomenon under review (Vlachos, 2001). This is especially true given that IFRS 7 has been revised on several occasions to take into account changing facts and circumstances, including user information needs and that revisions have been subject to due process (IASB, 2009; IASB, 2010c; IASB, 2010a; Li, 2010). The checklist included all IFRS 7 disclosures as at the end of each companies' respective year-ends covering the period 2008 to 2011. Where disclosure requirements were amended, deleted or introduced by subsequent revisions to IFRS 7, this was duly noted and accounted for. In addition, paragraphs or sub-paragraphs in IFRS 7 were broken down into individual disclosure requirements to ensure accuracy and completeness of the checklist. Each disclosure

requirement was cross-referenced to the respective provision(s) of the standard and sequentially numbered. The checklists included, on average, 273 individual disclosure items applicable from January 2007.

The researchers used a spreadsheet to administer the checklist. Where a disclosure requirement was complied with, a value of '1' was assigned. A 'nil' score was assigned when disclosures required by IFRS 7 were not found. Disclosure requirements that did not pertain to the entity were marked off as 'N/A'. The checklists were then totalled and a final 'IFRS 7 score' computed which represented the total disclosures made by the company as this bears to the total number of applicable disclosures required by IFRS 7. Where an amendment was introduced to IFRS 7 and was early adopted, a value of '1' was assigned to each respective disclosure. If the information was not yet disclosed, a 'N/A' was assigned. In this respect, the research assumes that any amendment to IFRS 7, by virtue of the due process followed by the IASB, would have provided decision-useful information. (Theoretically, it would, therefore, have been possible for a company to score in excess of 100% for its IFRS 7 disclosure[23]). In scoring each set of financials, the disclosure requirements were not ranked. In other words, each disclosure requirement was treated as equally relevant or useful for users. While this may be a simplifying assumption, it limits the introduction of researcher bias. Nevertheless, total elimination of subjectivity was not possible. Some measure of judgement was inevitably involved in concluding whether or not more complex IFRS 7 provisions had been complied with. These more complex cases were, however, limited and the researchers reviewed the conclusions reached in these more subjective instances. To further ensure validity and reliability of the results, the checklist was piloted on two companies over the four year period under review. No material errors or omissions were noted and it was concluded that the instrument was suitable for the purpose of the research.

Companies were scored over the same time period under comparable conditions (Vlachos, 2001) and were only included in the sample if they have been consistently included in list of top 40 JSE listed companies. This resulted in a sample of 29 companies over the four year period. This allowed the research to concentrate on those companies that represent a more substantial portion (greater than 67%) of the market capitalisation. The companies in the sample are also large companies which are under public scrutiny and are audited by one of Big Four firms, which helped ensure the quality of the financial statements and mitigate other variables, such as lack of depth in share trading, reliability of financial reporting, and quality

[23] During the scoring phase of the study, and because most Johannesburg Securities Exchange (JSE) listed companies have a June year end, it was impossible to obtain the annual reports for some of the companies, and therefore for these companies, N/A was scored

of governance systems impacting the results. As a final reliability safeguard, the researchers engaged in active peer review of the results, sequenced the checklists and cast and cross cast them to ensure accuracy.

Data and statistical tests

The IFRS 7 disclosures of 29 South African listed companies for the four years, starting from 2008 to 2011 were examined. Individual company characteristics, including the sector in which the companies operate, were not specifically considered. The paired samples t-test was used to determine whether there is a significant mean difference between the 2008 and 2011 IFRS 7 disclosure levels. Due to the relatively small number of companies included in the sample, we used the non-parametric Wilcoxon Signed Ranks test to corroborate the findings of the paired samples t-test. The research tested for a significant difference in the IFRS 7 scores for the 29 companies for the period 2008 to 2011 as well as whether or not there is a negative correlation between the IFRS 7 scores and the beta for each company. To test the strength of the linear relationship between the beta of the companies and the mean IFRS 7 disclosure level over the four years from 2008 to 2012 and the difference in IFRS 7 disclosure level of 2008 and 2011, the Pearson product-moment correlation coefficient was calculated. The non-parametric Spearman's Rank Order Correlation using the same measures was also calculated to verify the result of the Pearson's *r.*

4: Results

The IFRS 7 score was used to measure the extent of compliance with IFRS 7 by sampled companies. These figures were captured for each company for four consecutive years (2008 to 2011). Two aggregation measures were calculated: one to represent the average level of disclosure across the four years for each company and another to represent the increase in the extent of disclosure from 2008 to 2011. The average disclosure was determined by calculating the arithmetic mean of the disclosure level over the four years and the increase in disclosure was determined by calculating the difference between the 2008 and 2011 disclosure levels for each company. Finally, the 2011 beta values for each selected company were obtained from McGregor BFA. Table 1 lists the descriptive statistics for these three measures.

Table 1: Descriptive Statistics

	N	Range	Mean		Std. Deviation
	Statistic	Statistic	Statistic	Std. Error	Statistic
Leveraged Beta	29	2.0953	.818528	.0917916	.4943128
Average IFRS 7 Compliance (2008 to 2011)	29	135.25	114.7069	6.08168	32.75082
Increase of compliance from 2008 to 2011	29	103.00	22.2759	4.33479	23.34355
Valid N (listwise)	29				

Hypothesises

H1: There has been an increase in IFRS 7 disclosures from 2008 to 2011 by the top 40 JSE listed companies.

The 2008 and 2011 company disclosure data was subjected to a paired samples t-test to determine whether, on average, the compliance increased significantly over the last four years (mean difference in level between 2008 and 2011). The test demonstrated a statistically significant difference, at the 0.1% level of significance, between the mean compliance level of 2008 and 2011 ($t\ (28)=-5.139$, $p<.001$). More specifically, the mean compliance for 2011 (M=125.55, SD=36.34, n=29) is significantly higher than the mean compliance level for 2008 (M=103.28, SD=31.21, n=29). Results were confirmed by the non-parametric Wilcoxon Signed Ranks test. At the 0.1% level of significance, the null hypothesis of no increase in IFRS 7 disclosures from 2008 to 2011 can be rejected in favour of the research hypothesis. On average, it can therefore be concluded that the IFRS 7 disclosures by the top 40 JSE listed companies increased from 2008 to 2011.

These findings are also in line with the view that an increased focus on risk identification and management may be leading to more detailed financial disclosure. For example, King-III - introduced in 2009 - has placed an increased emphasis on companies to assess key risks and provide disclosures to enable users to understand the environment in which companies are operating (IOD, 2009). A similar message comes from the IRC and IIRC, both of whom maintain that better risk-based disclosure in integrated reports is paramount for improving the position of stakeholders and contributing to the long-term viability of firms (IIRC, 2011;

IRC, 2011). As part of this, organisations are expected to be more active in disclosing *both* financial and non-financial measures for users to make more informed decisions (IOD, 2009; Solomon, 2010). The above findings provide evidence in support of the former: That South African companies appear to be providing more comprehensive financial-based risk disclosure.

H2: The greater the extent of IFRS 7 disclosure over this period, the lower the respective company's beta

The hypothesis that the greater the extent of IFRS 7 disclosure, the lower the respective company's beta was tested by calculating the Pearson's product-moment correlation coefficient between the beta and (a) the mean level of disclosure over the four years and (b) the increase in the level of disclosure from 2008 to 2011. In both instances, the hypothesis was not supported. This lack of linear relationship between the beta and (a) the mean level of disclosure over the four years and (b) the increase in the level of disclosure from 2008 to 2011 was confirmed by the corresponding non-parametric Spearman's Rank Order Correlation coefficients. The beta demonstrated a very small negative, non-significant relationship with the average level of disclosure ($r(27)=-.082$, $p>.050$ and a small negative, non-significant relationship with the increase in level of disclosure from 2008 to 2011 ($r(27)=-.115$, $p>.05$).

These findings contrast with those Biddle et al (2009) and Heinle and Hofman (2011), who find that an increase in financial disclosure is associated with reduced over- or under-investment (used as a proxy to signal more informed decision making by stakeholders) or enhanced price efficiency respectively. Instead, what this paper's findings point to is the view that better reporting does not always equate with disclosing more (Steel, 1983). There is a growing concern that ever more disclosures mandated by IFRS, particularly in terms of IFRS 7, has resulted in an information overload where the marginal benefits of providing additional financial information are rapidly diminishing (Bradbury, 2012; Wallman, 1995). Going hand in hand with this is the fear that financial reporting is becoming more compliance-focused. Disclosures are provided, not because the preparer believes that the information will prove valuable for stakeholders, but due to an attitude of compliance where the aim is simply to 'check the box' (McMillan, 2004; Wallman, 1995).

5: Conclusion

This paper examined whether or not there has been an increase in the extent of disclosure compliance by a sample of top 40 companies per the JSE. IFRS 7 is concentrated on its broad applicability and the fact that it resonates with calls for more comprehensive risk-associated disclosures. The research also considered whether or not additional IFRS 7 disclosure lead to a reduction in perceived risk, measured by reference to company betas.

Some evidence is found to support the view that companies are making an effort to ensure compliance with the requirements of IFRS 7. This is consistent with the focus on improved financial reporting by, inter alia, the JSE, King-III and IRC. The hypothesis: that additional IFRS 7 disclosure would be synonymous with lower beta scores was not, however, supported. In turn, this provides additional evidence pointing to the fact that more disclosure does not always lead to more useful information for investors. What South African companies may need to take cognisance of is that approaching IFRS 7 as nothing more than a checklist, results in little value for stakeholders. As per King-III and the IRC, what is needed is a more holistic approach towards reporting that is mindful of providing balanced, meaningful insights into the nature of the entity's operations, key risks, management strategies and long-term viability.

In reaching this conclusion, a number of limitations must be noted. The research has only considered a sample of 29 South African listed companies over the period 2008 to 2011. Expanding this sample size and the time period under review would provide more robust results, as would the use of more sophisticated modelling to quantify the effects of other potentially relevant variables. Related to this, this paper has treated all IFRS 7 disclosure requirements as equally relevant. This is not necessarily the case (Dye, 1990). To this end, a type of factor analysis could be used to inform the development of a more detailed checklist that assigns user driven relevance scores to specific disclosure requirements to better examine the effect of IFRS 7 disclosures on assessed risk measures. Likewise, disaggregating the results by nature and type of operation; corporate social responsibility score and industry sector would provide more detailed results.

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