The value relevance of accounting in Swedish property companies before and after the introduction of IAS 40

A summary of the dissertation “Redovisningens värderelevans i svenska fastighetsbolag före och efter införandet av IAS 40”, published by Åbo Akademi Förlag, Finland

Introduction

The study focused on publicly quoted property companies in Sweden. These companies have from 1 January 2005 to follow new rules for reporting their investment properties. The companies studied have all made a change in their accounting principle from accounting on the basis of property acquisition cost to fair value accounting on the balance sheet.

Even before the year of 2005 property companies have had the opportunity and also the duty to evaluate their properties to fair values, but only as supplementary information. Following the introduction of IAS 40, property company values will be expressed in a clear and more comprehensive way, included as part of the balance sheet and thus also affecting the income statement.

The new method of accounting is aimed to describe a faire picture of the actual economic situation. However, it can also be assumed that the new method to account may contribute to a more subjective reporting, which would reduce the value relevance for the share market. The reasons for the decline in relevance may, for example, be the company management self interests. Another problem, which can be increasing, is specific interests from shareholders that may affect the accounting. The new way of accounting and reporting can therefore be argued have two sides, one “good” and one “bad”. The study will consider these aspects.

The research question

What does IAS 40 signify to the value relevance of accounting? There are a lot of aspects to this problem.

One of these is how the relationship between “on balance sheet reported equity” and the company's share price is at specified times and the changes that have occurred after the IAS 40 was applied. The question is interesting on the assumption that it is reasonable that the equity is the amount that shareholders have to "download" from the company through dividends or the sale of shares to another investor.

A *second* aspect is about the way changes in accounting rules may affect the share price just at the reporting moment (when the companies present their quarterly reports). Are movements in the share prices stronger after the IAS 40 came into force? This question is interesting in the light of the debate on whether or not flexible rules may create uncertainty among the actors on the share market.

A *third* aspect is the potential for increased flexibility in financial statements which IAS 40 may involve. Will variations in “on balance sheet reported equity” increase with the new framework? This question is interesting in light of the critical debate which exists that flexible accounting rules can be exploited in other interests than those of the shareholders.

A *fourth* aspect is how the variables "share market value" and "on balance sheet reported equity” correlates over time before and after the introduction of IAS 40. A good correlation over a slightly longer period of time may be an indication that the shareholders use the company's reporting as the basis for their decisions. There is also an opposite view that the market is more interested in the price movements themselves than in the company's reporting.

The following research issues will be studied:

a) What has happened to the quota “market value / on balance sheet reported equity” directly in the process of transition to IAS 40 and what does the further development look like?

b) Have changes occurred in movements in the share prices of property companies on reporting dates?

c) What are the changes of the variation in the “on balance sheet reported equity”?

d) Has the correlation between “on balance sheet reported equity” and the value on the share market been changed?

The purpose of the study is to illustrate whether and how the value relevance of accounting has changed in property companies as a result of the introduction of IAS 40 and to analyze the pattern observed in the variables "market value" and "on balance sheet reported equity".

Limitations in the study are:

The study will only investigate property companies in Sweden, which possess investment properties and which have been quoted during the entire study period. The major assets should consist of investment properties. Companies which are not part of a share listed group, but nevertheless voluntarily apply IAS / IFRS, are not included in the study.

The perspective of interest groups other than those of the investors will not be investigated. The concept of "fair value" is dealt with only on the basis of what is said in IAS 40. The reason is that only property companies with large holdings of investment properties are included in the study.

Empirical

The analysis is carried out on accounting data from December 2002 until March 2007. This leads to an equal number of measurement points before and after the introduction of IAS 40 in 2005. Date of measurement and analysis intervals are different in different companies, depending on the reporting days determined by the companies themselves within certain limits.

The analysis is also implemented on shares data that can be linked to specific reporting. An example of the methodology used is the Castellum Company concerning the report for the period January - March 2005 (Q1-05). This report was published on 20 April 2005. The company's next reporting date was July 19 in 2005. The period of share data is for this reason the period 2005.04.20 to 2005.07.18, and the data was evaluated against the values of the on balance sheet reported equity as stated in the company's accounting report Q1-05. This method has been applied to all measurement and for all the companies surveyed.

The number of quarterly reports that are included in the analysis of movements in share prices and variations in “on balance sheet reported equity” and analysis of correlation amounts to 18 and these are compared with the same number of analysis points concerning shares prices. All “share days” are included in the survey.

Sometimes a deterioration of “on balance sheet reported equity” can also lead to rising share prices. This depends on what is expected of the information actually obtained. The consequences can be anything in the relationship between the accounting information and share price, strong or weak, or in between. The link can also be negative. On a long-term basis, however, it may be assumed that expectations will accommodate to what has actually been reported and an adjustment of market value and “on balance sheet reported equity” will then take place. The short-term analysis has therefore only the aim to clarify if the investors react to the reporting in their decisions, but not how they react. The strength of the reaction, however, is also of interest. Is the reaction stronger than, for example, the reactions that result from other information published about the company and if the reaction is stronger than the average of all the reactions of an analysis period?

The study presented can also be seen in the perspective of "momentum studies" and "correlation studies." The former refer to reporting days and are implemented in such a way that the share price reported by the end of day will be compared with the closing price the day before reporting. These values are added together and divided after which an average is calculated. The resulting value shows the average percentage movements in the prices. The momentum studies analyze only one variable (either the “share market price” or the “on balance sheet reported equity”). The correlation studies refer to all “share days” and not only to the reporting days and here the relationship between the two variables is also considered.

Conclusions

The aim of the present study was to assess whether the introduction of IAS 40 - Investment Properties has contributed to larger value relevance for the actors in share market. The relationship between the share market and the company's accounts has been analyzed on the basis of variables "share price” and “on balance sheet reported equity”. The study is based on the assumption that there is a dependency between the company's share price and the company´s accounting in some way.

The new framework IAS 40 has been suggested to contribute with both positive and negative effects on the share market. The study contributes with an understanding of how it is in this respect. A better convergence of “on balance sheet reported equity” by the companies and their value on the share market has been achieved at the same time as the relationship with the share market has become more homogeneous between the companies investigated. The quota “market value / on balance sheet reported equity” has also been stabilized on a lower level after that the new regulatory framework was introduced.

A negative development is that movements in the share prices have increased in a time period when they have declined in other companies. (It must however be noted that even this may be perceived as a positive development among some players in the market). The increased movements in the share prices might be an indication that the share market reacts stronger to the information supplied after the introduction of IAS 40. One possible reason for increased movements in the share prices, however, is that the share market is responding to the fact that the information is provided and not on information contents itself.

The “on balance sheet reported equity” shows a higher variation after the change of rules was implemented. It should also be noted that the variations in the “on balance sheet reported equity” is substantially larger than the variations in the share price. This fact is valid both before and after the IAS 40 came into force.

The correlation between the variables "market value" (share price) and "on balance sheet reported equity" has been improved and the ratio of the variables is also stable. This means that variations in the variables "pull in the same direction" and that changes in the companies “on balance sheet reported equity”