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ASSESSING THE IMPACT OF THE MANDATORY CONVERSION TO IFRS ON NET INCOME IN SAUDI ARABIA

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Abstract

This study examines the impact of the mandatory conversion to IFRS on net income by analyzing the total and individual adjustments to IAS/IFRS in the reconciliations of net income for all Saudi companies listed on the Saudi Stock Exchange (Tadawul). This study uses a content analysis approach to examine the information cited by all companies listed on Tadawul in 2017. The study employs the comparability index for evaluating the impact of IFRS on net income. The results of the study show that there is a negative relationship between the depth of transitional disclosure provided in the reconciliation statements and the impact on earnings; however, the relationship is not significant. Moreover, the results indicate that the conversion to IFRS leads to a statistically significant decrease in 2016 net income for nearly 45.97% of sample firms at a 5% or more materiality level. Further, there is a statistically significant difference in the index values across the various sectors. The study reveals that 5 standards appear to cause significantly different impacts across sectors, which are: IFRS 9, IAS 37, IAS 39, IAS 40 and IAS 41. This study is useful to the accounting, auditing, and investing communities in knowing the impact of the conversion to IFRS on net income and which accounting standards affect companies' net income most.

Keywords: IFRS, Mandatory Requirements, Saudi Arabia, Impact, Earnings.

1. Introduction

Prior to the inception of Saudi Certified Public Accountants (SOCPA) in 1992, there was no unified set of accounting standards adopted in Saudi Arabia. Al Rumaihi (1997) describe ed the financial reporting environment in Saudi Arabia as following a mixture of accounting standards from the UK and USA. In order to cope with the modernization of the Saudi economy, many accounting academics and professionals called for the establishment of a standard setting body. In 1980, under the umbrella of the Ministry of Commerce, a local accounting firm started a project for the development of the accounting profession, Which ended in 1992 with the establishment of SOCPA. Regulations issued under Royal Decree No M/12 dated 13.05.1412H (1992 G) and operated under the supervision of the Ministry of Commerce entrusted SOCPA to promote the accounting and auditing profession. SOCPA issued the first batch of accounting standards in 1997 in accordance with US GAAP. From 1997 to 2003, 16 new standards were issued in addition to a modification to the disclosure and presentation standards. In 2002, SOCPA's board of directors revised its decision on the use of US GAAP in the absence of local standards. The board of directors issued a resolution number 5/2/1 requiring the use of International Accounting Standards (IAS) for subjects not covered by local standards or professional opinions issued by SOCPA.

However, in an era of globalization of businesses and markets, financial information prepared and audited according to national accounting Generally Accepted Accounting Principles (GAAP) no longer satisfies the needs of users whose decisions are more international in scope (Manduca, 2016). In addition, the Saudi economy is strongly interconnected with other economies in the world. Many Saudi listed companies have subsidiaries in other countries and many international companies have started to establish subsidiaries in Saudi Arabia. Also, most of the companies that are listed in TADAWUL have many large transactions with the international economy (Alsuhaibani, 2012). Saudi Arabia has recognized the need to participate in the opportunities offered by globalization; therefore, the SOCPA board formed a steering committee in 2010that comprises representatives of the Ministry of Finance, SAMA and Saudi stock exchange, in addition to the representatives of SOCPA accounting and auditing standards committees. The steering committees were requested to submit their recommendations for approval of the board with respect to the convergence of Saudi standards with international standards. The steering committee held various meetings in order to study the convergence matter and looked into studies prepared by SOCPA accounting and auditing committees. After careful deliberation, the steering committee decided on the plan to transition to the international standards. SOCPA approved an IFRS Convergence Plan called "SOCPA Project for Transition to International Accounting & Auditing Standards." SOCPA started this project in 2012 and completed it in 2016. In addition, SOCPA's stated goal for the project was to make a transition towards IFRS Standards after assuring their suitability to the Saudi environment through SOCPA's independent standard-setting process. Modifications were made to the IFRS to ensure the standards meet the sharia and local regulatory requirements. Starting from January 1, 2017, all listed companies are required to use IFRS Standards as endorsed by SOCPA.

Saudi accounting standards were issued by SOCPA and were based on IASs and USA GAAP, which were also influenced by Islamic and Sharia law, as for the application of Zakat and income tax standards (Alkhtani, 2010). Therefore, Saudi GAAP differs substantially from IFRS, which can be characterized as stakeholder-oriented and tax-driven. IFRS reporting is significantly more onerous than Saudi GAAP in that its application will necessitate additional disclosures that will contribute to better informing the users (Manduca, 2016). Transition to IFRS is important, since IFRS is being seen as a conduit for not only improving the quality of financial reporting but also as a tool for saving costs and improving performance (Al Sagga, 2015). Based on the principal differences between IFRS and SOCPA rules, it can be concluded that under SOCPA, companies had to recognize property and other similar assets at their historical cost, while with the adoption of IFRS, companies can report these items at their fair value. As such, adoption of IFRS allows companies to demonstrate a more current financial position and potentially create distributable reserves that otherwise would not exist. In addition, the adoption of IFRS enables complex groups to standardize both policies and procedures across operations, including those of internationally located subsidiaries (Al Sagga, 2015). Moreover, in some cases, IFRS allows more than one option for accounting treatments and one or more of the permitted criteria are already established in a SOCPA rule. This matter, which results in differences between the two standards, need not result in differences in practice. Consequently, this study examines the actual impact of IFRS on reporting by Saudi firms, since it is likely that not all differences between standards will produce variations in the financial statements prepared in the transition from one set of standards to the other.

Taking into consideration the substantial differences between IFRS and Saudi GAAP, the following research questions addressed by this study are:

1. Has the net income of Saudi listed companies been materially affected by the transition to IFRS?
2. Is there a difference in the impact across the sectors and to what extent is the impact on different sectors material?
3. Which standards cause the most material impact and appear most frequently across the different sectors?

This study contributes to the literature by providing evidence of the effects of the mandatory conversion to IFRS on reported net income of Saudi companies listed on Tadawul stock exchange and whether the conversion will improve the utility of financial reporting. This study will be the first of its kind that aims to explore the potential effects of the first-time adoption of IFRS in Saudi Arabia, as no further study has yet been published regarding this topic. At the same time, it will provide more recent information on the impact, since the investigation

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period covers the fiscal year 2017. This contribution may be useful to investors and user groups in terms of understanding the actual impact of IFRS on the net income of the companies they are investing in. Moreover, the result of the study may be helpful to academics involved in guiding and researching progress with international accounting harmonization, and to the ministry of finance, SAMA and Saudi stock exchange since the study provides insight into the results of implementing IFRS on the reported net income for Saudi listed companies.

2. Literature Review

Many studies have been conducted in many countries about the specific country's adoption of IFRS beginning from the year 2000. These studies focus on the effect of IFRS transition on the financial statements in general. Tsalavoutas and Evans (2007) adopted Hellman, 1993; Whittington, 2000; Bertoni and De Rosa (2006) by employing the comparability index for evaluating the impact of IFRS and earnings (ROE). However, the study expanded on previous studies by exploring the impact of IFRS recognition and measurement requirements on gearing and liquidity. In evaluating companies' reconciliation statements, the study found that 42 companies (17.6%) provided inadequate reconciliation disclosures, 5 provided reconciliation statements which did not allow identification of the individual standards effect, and the remaining 37 did not provide reconciliation statements. Overall, the findings suggested that the implementation of IFRS did indeed have a significant impact on the financial position of Greek listed companies with reference to shareholder's equity as well as gearing and liquidity ratios. Seven standards, which appeared in more than 50% of the companies examined, have significant contribution to these effects. However, in relation to the impact on performance with reference to net income and return on equity, the results were inconclusive.

Cordazzo (2008) provided empirical evidence of the nature and the size of the differences between Italian GAAP (IT) and IAS/IFRS, by analyzing the total and individual adjustments to IAS/IFRS in the reconciliations of net income and shareholders' equity of Italian listed companies. Overall, the findings indicated a more relevant total impact of such a transition on net income than shareholders' equity. The individual adjustments showed a more significant discrepancy between the two sets of standards in the accounting treatment of business combination, provisions, financial instruments and intangible assets with reference to both net income and shareholders' equity; while the individual accounting differences in income taxes, property, plant, and equipment showed a significant difference only on shareholders' equity.

O'Connell and Sullivan (2009) provide preliminary empirical evidence with respect to the effect on net income of IFRS adoption for some of the largest firms in the Eurozone area. Specifically, the study explored how the switch to IFRS has quantitatively impacted on the reported net income after extraordinary items of the constituents that adopted international standards for the first time. The finding revealed that net income for the sample firms for 2004 using IFRS was on average 9% higher than net income under domestic GAAP. Materiality was measured in terms of a 5% or 10% cut-off; nearly 75% of the sample firms reported a materially (at 5%) higher net income using IFRS as compared with domestic standards.

Stent *et al* (2010) examined the financial statement impacts of adopting NZ IFRS during 2005 through 2008. The effects of NZ IFRS on the financial statements and ratios of first-time adopters of NZ IFRS for a stratified random sample of 56 companies listed in New Zealand Stock Exchange (NZX). The study reported the magnitude of change in a particular financial statement element due to the adoption of NZ IFRS. Overall, the impact of NZ IFRS significantly increased assets, liabilities and net profit, but decreased equity. However, the impact on revenue was not significant at conventional levels. The study also analyzed the effect of NZ IFRS on key ratios, which serve as proxies for variables that may influence or be of interest to analysts. Changes in return on assets, leverage and asset turnover were not statistically significant for early adopters. For late adopters, the increase in leverage was significant at the 0.01 level. Return on equity and return on sales were significant for both early and late adopters at the 0.05 level.

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3. Methodology

Sample data

In accordance with the newly introduced IFRS, Saudi companies are required to prepare a reconciliation statement in Quarter 1, 2017 financial report. This study uses a content analysis approach to examine the information cited by all companies listed on Tadawul in 2017. Data is collected in 2017, as it is the most recent year for which company Quarter 1 reports are available. The data for this research is secondary in nature and obtained from two sources: (1) The Tadawul Stock Exchange website and (2) companies' online quarter 1 reports.

The sample of companies selected includes all companies listed on the Saudi Stock Exchange (Tadawul) as offiscal year 2017. However, banks and insurance companies were excluded because they are already following IFRS as required by Saudi Central Banks and Saudi Arabian Monetary Authority. In addition, companies under Real Estate Investment Traded Funds sector "REITs" were also excluded, because REITs adhere to the rules and regulations issued by the CMA. Thus from a total population of 184 listed companies on Tadawul, 127 companies were utilized in this study. In order to analyze the nature and the size of total and individual adjustments to IAS/IFRS, the reconciliation statements provided in Quarter 1, 2017 between SOCPA and IAS/IFRS has been evaluated. The reconciliation statements of 127 companies are examined at March 2016 and December 2016. Table 1.1 provides an analysis of the number of companies utilized in the study, disaggregated across each sector.

Table 1.1: Sample Companies

Sector	Number of companies (percentage)
Materials	42 (33.1%)
Capital Goods	12 (9.4%)
Consumer Durables & Apparel	5 (3.9%)
Retailing	6 (4.7%)
Consumer Services	6 (4.7%)
Energy	4 (3.1%)
Food & Beverages	12 (9.4%)
Pharma, Biotech & Life Science	1 (0.8%)
Utilities	2 (1.6%)
Diversified Financials	4 (3.1%)
Transportation	5 (3.9%)
Health Care Equipment & Svc	6 (4.7%)
Food & Staples Retailing	4 (3.1%)
Real Estate Mgmt & Dev't	10 (7.9%)
Media	2 (1.6%)
Commercial & Professional Svc	2 (1.6%)
Telecommunication Services	4 (3.1%)
Total	127

Research Method

This study first evaluates the reconciliation statements provided in the Quarter 1, 2017 financial report. The evaluation was performed on interim information for the first half of 2017 because this is the first period for which reconciliation statements for the financial statement are available under both IFRS and SOCPA. Depending on company fiscal year, Saudi companies provided reconciliation statements on March 2016 or December 2016 as Quarter 1, 2017 report. As required by IFRS, the first IFRS report should provide a reconciliation statement, which contains full balance sheets and income statements, each of which disclose SOCPA, IFRS and reconciliation adjustments for every line item in these financial statements, together with detailed notes explaining the adjustments, with specific reference to the relevant

IFRS standards. The evaluation was done to create three categories for classifying companies' transitional disclosures. Each company was awarded a simple score of 1-3 based on the following criteria:

1. Detailed – provided both reconciliation statement and additional narrative disclosures explaining the transition to IFRS.
2. Adequate – provided reconciliation statement but did not provide additional narrative disclosures.
3. Inadequate – did not provide reconciliation statement, did not provide narrative disclosure or provided inadequate narratives.

In addition, this study also examines whether the transitional information has any effect on the net income. In order to see whether there is a relationship between the impact on earnings and the transitional disclosures provided, a Pearson product-moment correlation coefficient will be used to test the following hypothesis:

H1: There is a positive relationship between the depth of transitional information and the net income.

Besides collecting data regarding the transitional information, this study also focused on providing empirical evidence on the nature and the size of the differences between SOCPA and IFRS by analyzing the total and individual adjustments to IFRS in the reconciliation of net income of Saudi listed companies. Then, the materiality test was performed to identify the magnitude/materiality of the change to the net income caused by the transition to IFRS. The level of discrepancy between SOCPA and IFRS is measured by the total comparability index (TCI) for evaluating the impact of IFRS on net income. This metric, which is used to compare SOCPA net income to that reported under IFRS, was first introduced by Gray (1980) as an 'index of conservatism' to compare the net income measurements of different countries. The same concept was adopted by Weetman et al. (1998) but was renamed 'the index of comparability' to shift the focus to comparability without regard to the issue of conservatism. Studieswhich have utilized the TCI include Adams et al. (1993), Street et al. (2000), Cooke (1993), Hellman (1993) and Norton (1995). The index is expressed by the formula:

$$TCI = 1 - \left(\frac{Net\ Income_{IFRS} - Net\ Income_{SOCPA}}{|Net\ Income_{IFRS}|}\right)$$

The net income figure obtained for each company is the consolidated net income available to ordinary shareholders after taxes and extraordinary items. In parallel to previous studies, this study also uses net income under IFRS as a denominator in order to assess the impact of IFRS on Saudi financial statements and to provide comparison with other studies focusing on other countries. A neutral value is 1, suggesting no change between the two standards. An index greater than 1 suggests that net income (loss) under SOCPA is higher than net income under IFRS. An index lower than 1 suggests that net income (loss) under SOCPA is lower than that reported under IFRS. As such, the following hypothesis is used to test the differences between the two standards:

H2: There is an increase in net income when a company adopts IFRS.

The hypothesis developed above implies the following predictions with respect to the TCI metric: H2 which predicts increase net income under IFRS implies that TCI < 1.

Based on the TCI calculation, the materiality of the results was determined. The materiality test is applied in this study to identify those companies which have material differences in overall net income. Although there is no agreed threshold of materiality, most researchers provide their result based on two bands of materiality threshold: 5% and 10% (Weetman & Gray, 1991; Weetman et al., 1998; Street et al., 2000). As such, this study will be in the same line by using 5% and 10% to check on the magnitude/materiality of the change on the net income caused by the transition to IFRS.

In addition to looking at the individual impact of the transition from SOCPA to IFRS, this study also looks at the impact from each sector to statistically test whether the transition to IFRS has a significant effect on net income of different sectors. This study calculates the mean and standard deviation of each sector impact on net income. Then, based on the result of mean and standard deviation, this study will perform statistical analysis to know if there is significant difference on net income across sectors because of the transition to IFRS. As such the following hypothesis is used:

H3: Transition to IFRS has a positive effect on net income across different sectors

This study predicts that the result of a significant positive relationship between transition to IFRS and the reported net income in different sector for the study period.
After the impact on the overall effect on net income for all the individual companies and for all the sectors, this study will also see the effect of transition to IFRS for each standard. For each of the companies, the reconciliation was grouped according to the relevant standards and the amount of adjustment was expressed as a percentage of total profit (loss) adjustment in the income statement. These percentages were then analyzed statistically and descriptive information produced. The one sample t-test is applied in order to test whether the IFRS reported net income was significantly higher or lower than the SOCPA reported net income. Furthermore, the non-parametric Kruskall-Wallis H test will be used to test the impacts from individual standards across sectors. The test is applied in order to know if there is a difference in the impact across the sectors, and to what extent is the impact on different sectors material.

4. Research Findings and Discussion

Reconciliation Statement

Table 1.2 shows the results from evaluating companies' reconciliation statements. The result reveals that 112 out of the 127 companies in the sample (88.2%) provided both reconciliation statements and additional, narrative disclosures explaining the transition to IFRSs. Whereas, 12 companies (9.4%) provided reconciliation statements but did not provide additional narrative disclosures explaining individual standards' effects and the remaining 3 (2.4%) did not provide either reconciliation statements or additional, narrative disclosures. Based on this result, it is clear that 88.2% of Saudi companies listed on TADAWUL comply with IFRS requirement regarding the reconciliation statement and the additional, narrative disclosures.

Transitional information	Number of companies (%)
Detail	112 (88.2%)
Adequate	12 (9.4%)
Inadequate	3 (2.4%)

Table 1.2: Transitional infomation

In order to see whether there is a relationship between the impact on earnings and the transitional disclosures provided, a Pearson product-moment correlation coefficient was performed. The result in table 1.3 reveals that the depth of transitional information hasa negative and very weak correlation with impact on earnings. The negative correlations indicate that the impact on earnings decreases as the depth of transitional information increases and vice versa. There is no statistically significant correlation since the Sig. (2-tailed) is equal to 0.854, which is greater than 0.05. The result indicates that there is a negative relationship between the transitional disclosures provided and the impact on earnings; however, the relationship is not significant. That means increases or decreases in the depth of transitional information do not significantly relate to increases or decreases in net income. Based on the result, hypothesis (H1) of a positive relationship between transitional information and net income is rejected.

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		Differences	Transitional information
Differences	Pearson Correlation	1.000	-0.017
	Sig. (2-tailed)	.	0.854
	N	124	124
Transitional information	Pearson Correlation	-0.017	1.000
	Sig. (2-tailed)	0.854	.
	N	124	127

Table 1.3: Pearson correlations

Net Income

The materiality test was performed to identify the magnitude/materiality of the change tothe net income caused by the transition to IFRS. The level of discrepancy between SOCPA and IFRS is measured by the total comparability index (TCI) for evaluating the impact of IFRS on net income. A neutral value 1 suggests no change between the two standards. An index greater than 1 suggests that net income (loss) under SOCPA is higher than net income under IFRS. An index lower than 1 suggests that net income (loss) under SOCPA is lower than that reported under IFRS. Table 1.4 and Figure 1 present the results based on level of discrepancy and the impact on net income.

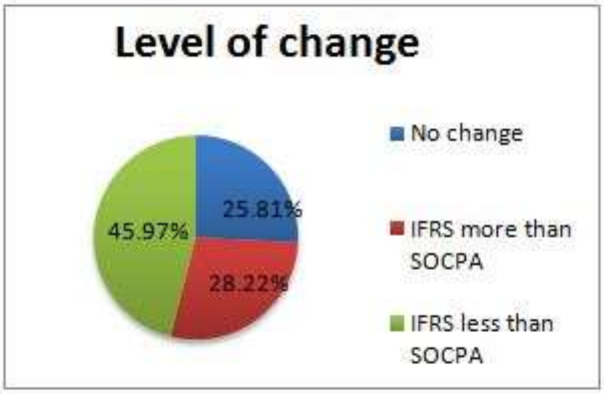

Figure 1: Level of change

The results show that of 124 companies (Excluding 3 companies, which did not provide reconciliation statements), 32 companies (25.81%) have a TCI equal to 1, which means no change between the net incomes under the two standards. Whereas, 57 companies (45.97%) have a TCI greater than 1 which indicates that the companies experience a decrease in net income (loss) when converting to IFRS, while 35 companies (28.22%) have an index lower than 1 that means the net income (loss) under SOCPA is lower than that reported under IFRS.

Table 1.4 illustrates that TCI ranges between 2.67 and-21.93 with a positive mean equal to 0.8269 and standard deviation equal to 2.0846. The mean is close to 1 but still different from 1, which means that net income (loss) under SOCPA is lower than that reported under IFRS. This result is inconsistent with the t-test result because the range between the minimum and maximum value is big. The dispersion of data (standard deviation) is big because the minus value is too big. That causes the mean to be of value less than 1. In addition, table 1.4 also details the results from a t-test that was conducted to determine if the mean value were significantly different from the neutral value of 1. The result shows the t-statistics of 4.417 which is statistically significant at p=0.000. Hence, the results indicate that net income for the sample firms is significantly higher in 2016 under SOCPA as compared with IFRS. This is true from Figure 1 above that shows 45.97% of the listed companies' net income under SOCPA is higher than IFRS. Based on the result, the hypothesis (H2) of an increase in companies' net income caused by the transition to IFRS is rejected. The results show that the conversion to

IFRS leads to statistically significant decrease in 2016 net income for nearly 45.97% of sample firms at a 5% or more materiality level.

Level of change	Number of companies Net income
Index=1 No change	13
IFRS > SOCPA	43
IFRS < SOCPA	68
Total number of companies	124
Mean	0.8269
Standard deviation	2.0846
Maximum value	2.67
Minimum value	-21.93
One sample t-test	t=4.417, p=0.000

Table 1.4: Impact on net income

Based on the TCI calculation, the materiality test is applied to identify those companies which have material differences in the overall net income. Table 1.5 shows the result for materiality impact. The result reveals that from 124 companies, 17 companies (13.71%) have an index value greater than or equal to 1.100, which means that their net income under SOCPA decreased by 10% or more due to the transition to IFRS. On the other hand, another 17 companies (13.71%) have an index value lower than or equal to 0.900, which means their net income under SOCPA increased by 10% or more due to the adoption of IFRS. In summary, 45.97%of Saudi listed companies faced material negative effect, while 25.81% saw no change, and 28.22%of the companies show higher income under IFRS at a 5% or more materiality level.

Level of Materiality	Index Values	Number of companies (percentage)
Net income decreased by 10% or more due to IFRS	≥ 1.100	17 (13.71%)
Net income is between 5% and 10% lower due to IFRS	1.050 – 1.099	8 (6.45%)
Net income is up to 5% lower due to IFRS	1.001 – 1.049	32 (25.81%)
Net income calculated under SOCPA and IFRS is equal	1.000	32 (25.81%)
Net income is up to 5% higher due to IFRS	0.950 – 0.999	15 (12.09%)
Net income is between 5% and 10% higher due to IFRS	0.901 – 0.949	3 (2.42%)
Net income increased by 10% or more due to IFRS	≤ 0.900	17 (13.71%)
Total		124

Table 1.5: Materiality impact

Impact Across Sectors

Table 1.6 reveals the result based on a total of 17 sectors. The finding reveals that from 17 sectors, only 6 sectors have been affected negatively, 10 sectors positively and one sector hasn't been affected by the transition. The second objective of this study was to explore whether there is a difference in the impact across the sectors. The result shows that there is a statistically significant difference in the index values across the various sectors. Therefore, hypothesis H3 is rejected. The study also reports the impact from individual standards on companies' net income across sectors. The results show that 5 standards have a significant relationship across sectors, which are: IFRS 9, IAS 37, IAS 39, IAS 40 and IAS 41.

Sectors	Total number of companies	Net Income		
		N	Mean	Standard deviation
Materials	42	40	1.080	0.307
Capital Goods	12	12	-0.943	6.631
Consumer Durables & Apparel	5	5	0.996	0.084
Retailing	6	6	0.980	0.017
Consumer Services	6	6	0.980	0.017
Energy	4	4	1.033	0.053
Food & Beverages	12	12	0.960	0.318
Pharma, Biotech & Life Science	1	1	1.310	
Utilities	2	2	0.635	0.502
Diversified Financials	4	3	0.937	0.110
Transportation	5	5	0.948	0.113
Health Care Equipment & Svc	6	6	1.015	0.015
Food & Staples Retailing	4	4	1.308	0.718
Real Estate Management & Development	10	10	0.877	0.393
Media	2	2	1.000	0.000
Commercial & Professional Svc	2	2	1.055	0.049
Telecommunication Services	4	4	0.928	0.080

Table 1.6: Average comparability index per sector

The statistical test result in relation to the impact of transition to IFRS across sector shows statistically significant at p=0.000. Based on the result, the hypothesis H3 is rejected.

Conclusion

The main objective of this study is to explore and identify the magnitude/materiality of the change on the net income caused by the transition to IFRS. This study concludes that the conversion to IFRS leads to statistically significant decrease in 2016 net income for nearly 45.97% of sample firms at a 5% or more materiality level. The second objective of this study is to explore if there is a difference in the impact across the sectors. The result shows that there is a statistically significant difference in the index values across the various sectors. The last objective is to identify which standards cause the most material impact and appear most frequently across the different sectors. The results show that 5 standards have a significant relationship across sectors, which are: IFRS 9, IAS 37, IAS 39, IAS 40 and IAS 41.

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