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The Incidence of Corporate Governance and IFRS on Information Asymmetry and the Value Relevance of Earnings: Some Canadian Evidence

Denis Cormier
Université du Québec à Montréal, École des sciences de la gestion

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***Corresponding address:**
P.O. Box 8888, downtown station
Montréal, Québec, Canada H3C 2P8
Cormier.denis@uqam.ca
Tel: 514 987 3000 (ext. 8358)

The Incidence of Corporate Governance and IFRS on Information Asymmetry and the Value Relevance of Earnings: Some Canadian Evidence

Abstract:

This paper examines how the advent of IFRS modified the role of corporate governance on information asymmetry between managers and investors and the value relevance of earnings. First, results suggest that corporate governance is associated with less information asymmetry on the market place as measured by bid ask spread and forecast dispersion. Second the advent of IFRS reduces the impact of corporate governance on information asymmetry. A partial substitution effect is observed. Third, results show that earnings are value relevant only for firms with good governance. Finally, it appears that migrating from Canadian GAAP to IFRS enhances the value relevance of earnings, but only for firms with good governance. This research highlights the importance to consider corporate governance when assessing the impact of IFRS adoption for stock market participants.

Key words. Corporate governance, IFRS, information asymmetry, value relevance of earnings.

L'incidence de la gouvernance d'entreprise et des IFRS sur l'asymétrie informationnelle et la pertinence des résultats comptables pour la valorisation boursière : Une étude canadienne

Résumé :

Cette recherche examine comment l'avènement des IFRS a modifié le rôle de la gouvernance d'entreprise sur l'asymétrie informationnelle entre les gestionnaires et les investisseurs et la pertinence des résultats pour la valorisation boursière. Premièrement, les résultats suggèrent que la gouvernance d'entreprise est associée à moins d'asymétrie informationnelle sur les marchés boursiers, telle que mesurée par le bid ask spread et la dispersion dans les prévisions d’analystes. Deuxième l'avènement des normes IFRS réduit l'impact de la gouvernance d'entreprise sur l'asymétrie informationnelle. Un effet de substitution partielle est observé. Troisièmement, il ressort que les résultats comptables ne sont pertinents pour la valorisation boursière que pour les entreprises ayant une bonne gouvernance. Enfin, il semble que la migration aux IFRS améliore la pertinence des résultats seulement pour les entreprises ayant une bonne gouvernance. Cette étude souligne l'importance de considérer la gouvernance d'entreprise pour évaluer l'impact de l'adoption des IFRS pour les participants du marché boursier.

Mots clés : Asymétrie informationnelle, gouvernance d’entreprise, IFRS, valorisation des résultats.

Introduction

Since 2011, most Canadian firms report their financial statements according to International Financial Reporting Standards (IFRS). The question whether or not IFRS meet their stated goals with respect to financial statements such as improving their relevance, quality, and comparability is of interest. In other words, beyond IFRS adoption, do their implementation and the enforcement of such implementation through corporate governance bring benefits to market participants? Our purpose is to address this issue. Toward that end, considering corporate governance, we analyze if IFRS-based earnings bring incremental information benefits to investors compared with made-in-Canada Generally Accepted Accounting Principles (GAAP) used prior to 2011.

Prior research documents that corporate governance may affect information asymmetry between managers and investors. In this paper, we address the following research questions. First, does the advent of IFRS modify the role of corporate governance on information asymmetry between managers and investors? Second, do corporate governance and the advent of IFRS affect the value relevance of earnings?

Results are the following. First, findings suggest that corporate governance is associated with less information asymmetry on the market place as measured by bid ask spread and forecast dispersion. Second the advent of IFRS reduces the impact of corporate governance on information asymmetry. A partial substitution effect is observed. Third, results show that earnings are value relevant only for firms with good governance. Finally, it appears that migrating from Canadian GAAP to IFRS enhances the value relevance of earnings, but only for firms with good governance. This research highlights the importance to consider corporate governance when assessing the impact of IFRS adoption for stock market participants. Overall, this paper provides evidence suggesting that that IFRS self-proclaimed goal of providing investors with relevant information is achieved in the Canadian context.

Our study contributes to accounting and corporate governance literatures in at least two ways. We contribute to the literature on IFRS by studying the impact of corporate governance on information asymmetry prior versus under IFRS. Second, we contribute to the literature on the stock market valuation effects of mandatory IFRS adoption by investigating the value relevance of earnings integrating the quality of corporate governance. As far as we know, this is the first study to address this issue.

The remainder of the paper is organized as follows. Section 2 provides background and the development of hypotheses. Section 3 presents the methodology. Section 4 discusses the results. Finally, Section 5 concludes and discusses the implications of the study.

2. Background and hypotheses

2.1 Governance and information asymmetry

Corporate governance should lead to greater transparency, which enhances stock market liquidity, and reduces transactions costs for a firm’s stock (Diamond and Verrecchia, 1991). Several approaches coexist for the purpose of assessing a firm’s information asymmetry. Kanagaretnam et al. (2007) document that changes in bid–ask spreads at the time of earnings announcements are negatively related to board independence, board activity, and the percentage stock holdings of directors and officers. Their results are consistent with the view that firms with higher levels of corporate governance have lower information asymmetry around quarterly earnings announcements.

A few studies document an association between corporate governance and stock returns or firm value (e.g. Gompers et al., 2003; Beiner et al., 2006).
Focusing on European firms, Vander Bauwhede and Willekens (2008) argue that firms disclose corporate governance information to reduce information asymmetry and agency costs stemming from the separation between ownership and control, thus improving investor confidence in financial reporting. Using ratings on corporate governance disclosure issued by an independent rating agency, the authors show that the level of disclosure is lower for firms with higher ownership concentration and higher for companies from common-law countries. In the Canadian context, Cormier et al. (2010) show that some formal monitoring attributes (board and audit committee size) reduce information asymmetry.

2.2 IFRS and information asymmetry

Overall, prior evidence suggests that even for a country categorized by strong investor protection and high-quality financial reporting and enforcement, IFRS adoption improves the value relevance of financial reporting for stock market participants.

Considering that Canada is a country with a strong enforcement, we do expect IFRS adoption to translate into a positive outcome for investors.

There is some evidence that a switch from domestic standards to IFRS has a modest positive impact on market liquidity and the cost of equity capital, most likely resulting from the reduction in information asymmetry between investors and managers following the implementation of IFRS (Daske et al. 2008; Bruggermann et al. 2009). However, firms that voluntarily adopt IFRS ahead of the mandated year of adoption experience a stronger improvement in the liquidity of their stock and in their cost of capital than firms that only adopt IFRS at the required date. Therefore, it is unlikely that IFRS adoption in itself drives the improvement in the information set that is available to investors: other regulatory or institutional changes probably take precedence. In this vein, Byard et al. (2011), based on a European sample, find that analysts' absolute forecast errors and forecast dispersion decrease relative to a control sample only for those mandatory IFRS adopters domiciled in countries with both strong enforcement regimes and domestic accounting standards that differ significantly from IFRS.

Focusing on the European Union, Christensen et al. (2013) show that IFRS adoption has a beneficial impact on market liquidity only for firms in those countries that tightened their reporting enforcement. They conclude that, by itself, the change in accounting standards seems to have had little effect on market liquidity.

Landsman et al. (2012) investigate whether the information content of earnings announcements increases after mandatory IFRS adoption, based on observations from 27 countries from 2000 to 2007 (16 countries' adoption of IFRS and 11 countries' remaining adoption of domestic accounting standards). Abnormal return volatility and abnormal trading volume are used as proxies for the information content of earnings announcements. The authors find that the information content increased in IFRS-adopting countries, but this happens only when they use abnormal return volatility (not abnormal trading volume) as a proxy for information content. Moreover, they find that increases in abnormal return volatility are concentrated in code law countries.

Hence, overall, the evidence with respect to IFRS impact on financial reporting relevance is rather mixed, and potentially conditional on the strictness of legal enforcement.

In a context of strict legal enforcement such as Canada, we posit that both corporate governance and IFRS should improve market liquidity and reduce information asymmetry.

Hence, the following hypothesis:

> H1. There is a substitution effect between corporate governance and the advent of IFRS on their impact on information asymmetry.

2.3 Corporate governance, IFRS and value relevance of earnings

In the context of Australia, a country categorized by strong investor protection laws and active enforcement, and using a longitudinal study that covers pre-IFRS and post-IFRS periods during 1990 to 2008, Chalmers et al.'s (2011) find an increase in the value relevance of earnings post IFRS. Their study suggests that the impact of IFRS-based financial information on financial markets may be driven by a country's institutions regarding investor protection and enforcement, both dimensions underlying high quality financial reporting. Moreover, the use of IFRS information allows firms to improve their coverage by foreign financial analysts as well as the accuracy of their forecasts, especially in countries with high investor protection (Byard et al. 2011). Hence, an increase in relevance for stock markets is observed for firms highly followed by analysts.

Hence, overall, the evidence with respect to IFRS impact on financial reporting relevance potentially conditional on the strictness of legal enforcement.

Concerning governance, Chang and Sun (2009) argue that the passage of Sarbanes-Oxley Act (SOX) marks the beginning of firms' mandatory disclosure of the audit committee composition and other corporate governance information. They posit that SOX improves the effectiveness of an independent audit committee and other corporate governance functions in monitoring the earnings quality of cross-listed foreign firms. They measure the earnings quality by the sample firms' earnings informativeness (i.e. earnings response coefficient) and earnings management. Their findings show significant positive associations between earnings informativeness and audit committee independence as well as board independence in the post-SOX period. In contrast to the post-SOX results, they do not find a significant association between earnings informativeness and audit committee independence in the pre-SOX period. Furthermore, their results show a positive (negative) association between earnings informativeness (earnings management) and an aggregate corporate governance score, which is a measure of overall corporate governance functions.

Verriest et al. (2011) find that European firms with strong corporate governance mechanisms engage in higher financial reporting quality around the moment of first-time IFRS adoption. Further, the authors notice that firms with more independent boards, more active boards and especially firms with more effective audit committees disclose substantially more information about the impact of IFRS on their financial statements. They also find that strong governance firms disclose more extensively on specific IFRS disclosure standards. Finally, their results suggest that strong governance firms use the timing adoption flexibility in a conservative fashion while weak governance firms tend to use this option in an opportunistic fashion.

Given the importance of corporate governance on the impact of IFRS on the value relevance of earnings, we test the following hypothesis:

> H2. Corporate governance enhances the value relevance of earnings to a larger extent under IFRS.

3. Method

3.1 Sample

The sample is based on Canadian firms composing S&P/TSX index of the Toronto stock exchange for years 2009 (Canadian GAAP) and 2011 (IFRS). The index comprises 233 firms. From this sample, there are missing data for 13firms (data not available for both years). From the sample of 220 firms, 36 firms use the same set of

GAAP for 2009 and 2011 (so-called no-change firms): 17 firms are complying with US-GAAP and 19 firms have a year-end after April 30 or IFRS adoption is postponed for different reasons (e.g. regulated industries). For firms with year-end after April, the data in Compustat database are for 2009 and 2010, i.e. prior to IFRS adoption. This gives a sample of 184 firms. We have missing data for governance (4 firms for Governance Board Games, 32 for ISS Governance score), for forecast dispersion (18 firms), and 3 firms for stock price

Table 1

Sample description

Firm-year observations

	Board Games	ISS Governance score	Board Games	ISS Governance score	Board Games	ISS Governance score
	BAS	*BAS*	*FORDIS*	*FORDIS*	*PRICE*	*PRICE*
Sample	368	368	368	368	368	368
GOV	(8)	(64)	(8)	(64)	(8)	(64)
FORDIS			(36)	(36)		
PRICE					(6)	(6)
Final sample	360	304	324	268	354	298

For year 2010, Canadian firms must report earnings and balance sheet reconciliations between Canadian GAAP and IFRS. However, financial statement numbers are still presented in Canadian GAAP. We decided not to include year 2010 to avoid confusion and to focus on clear Canadian GAAP and IFRS years. Financial data was collected from Compustat and Stock Guide. Governance scores come from Board Games ranking (The Globe &Mail) and from ISS Governance Quick score. Sample firms operate in the following industries: Financial; Real Estate; Materials; Energy; Industrials; Consumer discretionary; Consumer staple; Utilities; Telecommunications; Information technology; and Health care.

3.2 Empirical Models

To assess the incidence of corporate governance and the advent of IFRS on information asymmetry and on the value relevance of earnings, we develop the following empirical models.

Corporate governance and IFRS: Incidence on information asymmetry

BAS =

*LnVOLUME +LnVOLATILITY + GOV + GOV*YIFRS + YIFRS*

FORDIS =

*BETA + ANFOL + NEGEPS + GOV + GOV*YIFRS + YIFRS*

Corporate governance and IFRS: Incidence on stock market valuation

The valuation model is inspired by the work of Feltham and Ohlson (1995) and Amir and Lev (1996). Such a model maps a firm's book value and earnings into its stock market valuation.

PRICE =

*EQPS + EQPS*YIFRS + EPS + EPS*YIFRS + EPS*GOV + EPS*GOV*YIFRS*

*+ GOV*YIFRS + GOV +YIFRS (3)*

Where: *LnVOLUME:* Natural log of trading volume; *LnVOLATILITY:* Natural log of share price volatility; *BETA: Systematic risk (beta); ANFOL:* Number of analysts following a firm; *BAS*: Bid ask spread; *GOV*: Governance score; *YIFRS*: Year for financial reporting under IFRS; *EQPS*: Equity per share; *EPS*: Earnings per share.

3.3 Definition of variables

GOV. Vafeas (2000) finds that earnings are more informative for companies with more effective boards while Dey (2005) reports that earnings credibility increases with board quality. These findings suggest that higher corporate governance quality should be associated with less information asymmetry and improve analyst forecast accuracy. A negative (positive) association is expected between *GOV* and BAS (*FORDIS*). Two governance scores are used. The first one is based on Board Games (The Globe and Mail's annual report on corporate governance)[1], which includes four components: 1) board composition; 2) shareholding and compensation; 3) shareholder rights; and 4) disclosure. The grid is based on a total of 100 marks (Board composition; 31 marks; Shareholding and compensation: 26 marks; Shareholder rights: 31 marks; Disclosure: 12 marks). The second score is based on ISS Governance Quick score. The grid is based on a total of 10 marks, 1 meaning an excellent and 10 meaning a weak score. The score is based on board structure, compensation, shareholder rights, and the audit. To facilitate interpretations, we change the score so that an excellent score is 10 instead of 1 (10 - total score +1).

LnVOLUME and *LnVOLATILITY*. Prior research document that trading volume and share price volatility are fundamental determinants of bid ask spreads. An inverse relationship between spreads and trading activity is expected (Demsetz, 1968). Price volatility is also a determinant of bid ask spreads and as such incorporated in information asymmetry models of the spread (e.g. Copeland and Galai, 1983; Aitken and Frino, 1996). Hence, we expect a negative (positive) relationship between BAS and *LnVOLUME* (*LnVOLATILITY*). The logarithmic transformation of these two variables is used to reduce the skewness and potential heteroscedasticity problems (Aitken and Frino, 1996).

BETA. Patton and Verardo (2010) observe that the increase in systematic risk is greater for earnings announcements with larger positive or negative surprises, and with

[1] The Globe and Mail is Canada's leading financial newspaper in terms of reach and readership. Its governance survey has been widely used in prior research (e.g., Klein *et al*., 2005).

greater analyst forecast dispersion. We expect a positive association between *BETA* and *FORDIS.*

ANFOL. Analyst forecasts precision is likely to improve, as more information about a company is processed and disclosed by analysts (Alford and Berger, 1999). Hope (2003a) documents a negative relationship between analyst following and forecast error. Thus, a negative association is expected between *ANFOL* and *FORDIS*.

NEGEPS. Hope (2003a) documents that negative earnings are associated with more forecast error, suggesting that earnings is more difficult to predict for companies that experience losses. Consistent with Hope (2003a, b), an indicative variable for negative earnings is used. We anticipate a positive relationship between this binary variable and *FORDIS*.

4. Results

4.1 Descriptive statistics

Table 2 provides some descriptive statistics about sample firms' financial variables under Canadian GAAP versus IFRS. We document a decrease in information asymmetry following the adoption of IFRS in Canada. Hence, we observe a decrease in bid ask spread, in forecast dispersion, in share price volatility. We also observe an increase in liquidity as characterized by a higher level of trading activity. Finally, analyst following has increased from Canadian GAAP period to post IFRS.

Table 2

Descriptive statistics

	Canadian GAAP (2009)		IFRS (2011)	
	Mean	Median	Mean	Median
EPS	1.10	0.57	1.49	1.02
EQPS	14.401	10.428	11.961	9.855
FORDIS	0.010	0.026	0.008	0.011
BAS (%)	0.686	0.444	0.386	0.258
VOLUME (annual in millions)	31.5	11.6	35.0	14.1
VOLATILITY	68.787	63.786	35.231	31.860
BETA	1.917	1.141	1.661	1.194
ANFOL	6.769	6.0	8.144	8.0
NEGEPS	0.274	0	0.179	0

EQPS: Equity per share; *EPS*: Earnings per share *FORDIS:* Forecast dispersion scaled by lag price*; BAS*: Bid ask spread; *VOLUME*: Trading volume; *Volatility*: Share price volatility; *ANFOL*: Number of analysts following a firm; *NEGEPS*: Negative EPS (1/0); *GOV*: Governance score.

Table 3 reports on the governance scores. For Board Games, the mean total score is 63.22. Board composition (19.06) and Shareholder rights (20.63) present the highest mean scores. Considering the maximum scores allowed within each component, we get a mean relative score of 0.66 for Board composition (19.06/29), 0.55 for Compensation

(15.49/28), 0.67 for Shareholders rights (20.63/31) and 0.68 for Disclosure (8.17/12). For ISS Governance Score, board structure (5.53), compensation (5.34) and shareholder rights (4.97) show quite similar scores.

Table 3

Governance score by components 2009/2011

	Mean	Std. Dev.	Min.	Max
Board Games				
Board composition	19.059	5.094	1	29
Compensation	15.485	5.969	2	28
Shareholder rights	20.634	5.959	2	31
Disclosure	8.173	5.086	1	12
Total	63.217	16.082	27	96
ISS Governance score				
Board structure	5.526	5.090	1	10
Compensation	5.335	2.783	1	10
Shareholder rights	4.973	2.821	1	10
Audit	1.178	1.260	1	10
Total	5.431	2.790	1	10
Adjusted Total*	5.461			

*10 – Total +1

4.2 Multivariate results

We estimate regressions using OLS with robust estimators since the Breusch-Pagan / Cook-Weisberg tests show the presence of heteroscedasticity. Durbin-Watson tests do not reveal autocorrelation problems (statistic close to 2.0 in all regressions). Moreover, multicollinearity is not an issue in any regressions since the highest variance of inflation factor is 4.0. Finally, we exclude from regressions all observations with standardized residuals exceeding two.

Table 4 reports on the relation between corporate governance, the adoption of IFRS and information asymmetry. Based on prior literature, *LnVOLUME* and *LnVOLATILITY* are used as control variables in bid ask spread regressions and *BETA*, *ANFOL* and *NEGEPS* in forecast dispersion regressions. All coefficients except for *ANFOL* are significant and in the predicted direction.

Results suggest that corporate governance is associated with less information asymmetry on the market place as measured by bid ask spread and forecast dispersion. Using two different proxies for corporate governance (Board Games and ISS Quick Score) and for information asymmetry (Bid ask spread and forecast dispersion), as expected, results show a negative relationship between *GOV* and *BAS* and a positive relationship between *GOV* and *FORDIS*. Also as expected, the advent of IFRS reduces the impact of corporate governance on information asymmetry, suggesting a partial substitution effect (*GOV*IFRS* is positive and significant in all regressions). This is consistent with hypothesis 1.The substitution effect is not complete since the joint tests of the sum of coefficients *GOV* and *GOV*YIFRS* are different from zero in three regressions out of four.

Table 4

OLS Regressions – Robust estimators

Relevance of governance for information asymmetry

	BAS		*FORDIS*	
	Board Games	ISS Quick Score	Board Games	ISS Quick Score
LnVOLUME	***-0.068	***-0.065	-	-
LnVOLATILITY	***0.195	***0.211	-	-
BETA	-	-	***0.005	***0.006
ANFOL	-	-	-0.001	-0.001
NEGEPS	-	-	**0.005	**0.008
GOV	***-0.010	***-0.039	***-0.032	***-0.149
*GOV*YIFRS*	***0.007	***0.027	***0.028	**0.075
YIFRS	***-0.526	***-0.251	***-0.024	**-0.010
Joint test (F test)				
*GOV+GOV*YIFRS*=0	17.11(0.00)	5.54(0.02)	0.34(0.56)	2.98(0.08)
R-Square	34.3%	27.4%	39.2%	42.7%
F-Statistic	21.1(0.00)	11.4(0.00)	5.8(0.00)	3.9(0.00)
N	360	304	324	268

BAS: Bid ask spread; *FORDIS*: Forecast dispersion scaled by lag Price; *LnVOLUME*: Natural log of trading volume; *LnVolatility*: Natural log of share price volatility; *ANFOL*: Number of analysts following a firm; *NEGEPS*: Negative EPS (1/0); *GOV*: Governance score; *YIFRS*: Year for financial reporting under IFRS.

Table 5 reports on the value relevance of earnings considering corporate governance and the adoption of IFRS. First, results show that earnings are value relevant only for firms with good governance (Board Games: *EPS*GOV* = 0.063; $p < 0.01$; ISS Quick Score: *EPS*GOV* = 0.399; $p < 0.01$). Second, it appears that migrating from Canadian GAAP to IFRS enhances the value relevance of earnings, but only for firms with good governance (Board Games: *EPS*GOV*YIFRS* = 0.050; $p < 0.05$; ISS Quick Score: *EPS*GOV*YIFRS* = 0.871; $p < 0.05$). Consistent with hypothesis 2, corporate governance enhances the value relevance of earnings in a larger extent under IFRS. This research highlights the importance to consider corporate governance when evaluating the impact of IFRS adoption for stock market participants.

Table 5

OLS Regressions – Robust estimators

Relevance of earnings for stock price valuation

	Board Games	ISS Quick Score
EQPS	***0.826	***0.924
*EQPS*YIFRS*	*-0.202	-2.149
EPS	-1.466	0.228
*EPS*YIFRS*	-2.833	1.691
*EPS*GOV*	*****0.063**	*****0.399**
*EPS*GOV*YIFRS*	****0.050**	****0.871**
GOV	*****0.084	0.168
*GOV*YIFRS*	-0.024	*-2.298
YIFRS	0.216	*34.163
Joint test (F test)		
*EPS*GOV-EPS*GOV*YIFRS*=0	0.05(0.82)	0.49(0.48)
R-Square	88.8%	53.9%
F-Statistic	297.6(0.00)	106.6(0.00)
N	354	298

EQPS: Equity per share*; EPS:* Earnings per share; *GOV:* Governance score*; YIFRS:* Year for financial reporting under IFRS.
*: $p < 0.10$; **: $p < 0.05$; ***: $p < 0.01$.

5. Conclusion

This paper investigates how the advent of IFRS affects the role of corporate governance on information asymmetry between managers and investors and the value relevance of earnings. We bring some evidence that migrating from Canadian GAAP to IFRS provides investors with more relevant information by reducing the information gap between managers and investors. First, the advent of IFRS coincides with an increase in analyst following and trading volume, a reduction in bid-ask spread, and analyst forecast dispersion. Second, IFRS enhance the value relevance of earnings. Second, results suggest that corporate governance is associated with less information asymmetry on the market place as measured by bid ask spread and forecast dispersion. Third, the advent of IFRS reduces the impact of corporate governance on information asymmetry. A partial substitution effect is observed. Fourth, results show that earnings are value relevant only for firms with good governance. Finally, it appears that migrating from Canadian GAAP to IFRS enhances the value relevance of earnings, but only for firms with good governance. This research highlights the importance to consider corporate governance when assessing the impact of IFRS adoption for stock market participants. As far as we know, this is the first study to investigate the value relevance of earnings integrating the quality of corporate governance.

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