THE APPROPRIATENESS OF RULES-BASED HEADLINE EARNINGS GUIDANCE FOR LISTED PROPERTY ENTITIES ON THE JSE LIMITED

by

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DECLARATION

I, Tendani Sikhwivhilu declare that **THE APPROPRIATENESS OF RULES-BASED HEADLINE EARNINGS GUIDANCE FOR LISTED PROPERTY ENTITIES ON THE JSE LIMITED** is my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.

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Signature Date

Tendani Sikhwivhilu

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Terminology and abbreviations used in this study:

AITF	Accounting Issues Task Force
CFO	Chief Financial Officer
ED	Exposure Draft
EPS	Earnings Per Share
FASB	Financial Accounting Standards Board
HEPS	Headline Earnings Per Share
IAS	International Accounting Standards
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 33	Earnings Per Share
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFRS	International Financial Reporting Standards
IFRS 9	Financial Instruments
IFRS 13	Fair Value Measurements
IIMR	Institute of Investment Management and Research
JSE	JSE Limited
MoU	Memorandum of Understanding (MoU)
P/E	Price/Earnings
SEC	Securities Exchange Commission
SAICA	South African Institute of Chartered Accountants
The Circular	SAICA Circular 2/2013 – Headline Earnings
USA	United States of America
US GAAP	United States of America's Generally Accepted Accounting Principles

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Abstract

The disclosure of headline earnings is one of the JSE Limited (JSE)'s listing requirements. All listed entities are required to comply with this disclosure requirement. Guidance in the form of The Circular on headline earnings is issued by the South African Institute of Chartered Accountants (SAICA), and is updated every time when there are changes to the International Financial Reporting Standards (IFRS). The Circular adopts a rules-based approach and specifies what is included and excluded in the calculation of headline earnings. The rules consist of general rules, which apply to all entities other than those industry groups with special provisions such as the life insurance entities.

This study questions whether a rules-based headline earnings approach or a principles-based approach is more appropriate for the calculation of headline earnings of listed property entities on the JSE, for economic decision-making purposes. The research method consisted of questionnaires that were sent out to stakeholders. The responses from the CFOs and investment analysts show that principles-based headline earnings guidance is preferred over rules-based headline earnings guidance.

Keywords: JSE, SAICA, IFRS, headline earnings, CFO, rules-based, principles-based

Chapter 1: Introduction

1.1 BACKGROUND INFORMATION

Headline Earnings Per Share (HEPS) is widely used as a measure of performance in South Africa (Venter, Cahan & Emanuel, 2013:28; Stainbank & Harrod, 2007:111). In fact, all entities listed on the JSE Limited (JSE) are required to apply the latest circular, which is Circular 2/2013 as issued by the South African Institute of Chartered Accountants (SAICA) (Venter, *et al,* 2013:28). The objective of the SAICA Circular 2/2013 *Headline Earnings* (here in referred to as "The Circular") is to provide guidance on how to calculate headline earnings. This is achieved by providing rules for all items of income or expense that are to be included, and those items to be excluded from the calculation of the headline earnings figure, to ensure consistent application across entities and across periods of time (SAICA, 2013:8).

Although HEPS can be used as a measure of performance, it is the view of the International Accounting Standards Board (IASB) that there is no single number that encapsulates the performance of an entity (SAICA, 2013:5). Barton, Hansen and Pownall (2010:753) also found that there is no performance measure figure that is dominant around the world. The users of the financial statements are expected to consider the financial statements as a whole in making economic decisions (SAICA, 2013:5).

According to The Circular, *"The headline earnings survey carried out by SAICA in 2006 and subsequent interviews with various user groups, including fund managers, analysts and financial institutions, showed a large demand from users in general for a clearly defined reference number (other than the earnings per share number in terms of IAS 33 – Earnings per Share), which can be used for reporting and comparative purposes.*" (SAICA, 2013:5). Some respondents believe that headline earnings should exclude items that relate to the capital platform of an entity such as the revaluation of certain assets (e.g. investment property), which are included in the earnings calculated in terms of IAS 33 (SAICA, 2013:5). Hence, the conclusion was that there is a need for the circular on headline earnings.

In terms of The Circular, the calculation of the headline earnings figure is expected to reflect a more consistent performance figure, since it excludes earnings items that do not relate to the operating/trading activity of an entity, and EPS in IAS 33 includes all earnings (SAICA, 2013:5). In addition, it is believed that the detailed rules provided in determining the headline earnings are likely to provide a better performance indicator than EPS calculated in terms of IAS 33 (SAICA, 2013:4).

The EPS figure is a key ratio that is used to evaluate the entity's performance, and can be used to compare one entity's performance to another (Stainbank & Harrod, 2007:91). Studies have revealed that there is a positive correlation between the share price and EPS (Cheng & Warfield, 2005:470-471; Seetharaman & Raj, 2011:114). The underlying assumption in the price-earnings (P/E) valuation model is that the earnings have been correctly computed and that the share price is determined on a rational basis (Cheng & Warfield, 2005:470-471). In the South African context, this means that the guidance within which HEPS is based is of critical importance in providing useful financial information to users in making economic decisions.

One way of determining the entity's value is using the P/E ratio that relies on the reliability of the headline earnings figure (SAICA, 2013:5). This means, if the entity has a higher P/E ratio, such an entity is believed to have a higher value than an entity with a low P/E ratio. Therefore, investors would expect an entity with a higher P/E ratio to generate higher cash flows in the future (Wilcox, 2007:55). This expectation could influence management to overstate an entity's earnings.

The manipulation of earnings will result in a misrepresentation of the P/E ratio. Consequently, a manipulation of the P/E ratio will lead to the manipulation of the entity's value, which means that the entity's future cash flows will also be misrepresented (Seetharaman & Raj, 2011:114; Wilcox, 2007:64). The extent, to which management has the latitude to manipulate the content of the financial statements, depends on whether the accounting standards are based on well-defined principles or clearly stipulated rules (Alles & Datar, 2003:120).

Principles-based accounting standards can be defined as those standards which provide high-level guidance with little, if any, operational guidance (Benston, Bromwich & Wagenhofer, 2006:169). Both preparers and auditors are expected to exercise judgement in accounting for transactions, using high-level guidance provided in the principles-based accounting standards (Benston, *et al,* 2006:170). Rules-based accounting standards, on the other hand, can be defined as those standards that provide detailed guidance on implementation and compliance and provide little if any room for interpretations (Benston, *et al,* 2006:170). Therefore, two professionals presented with the same information may come to different conclusions using principles-based accounting standards, depending on the interpretation of the facts. In this respect, a rules-based approach is favoured, since it is unlikely to be subject to manipulation by management with a view of managing earnings.

1.1.1 Rules versus principles

According to a widely held view, U.S. accounting standards are more rules-based than principles-based (Benston, *et al,* 2006:165). On the other hand, IFRS standards are generally considered to be principles-based (McEnroe & Sullivan, 2012:32).

The Circular provides detailed rules on what is included, and excluded, from the headline earnings figure, and The Circular states that any deviations from the rules will result in undesirable inconsistencies from one entity to another (SAICA, 2013:8). Therefore, entities are not permitted to override a rule, even if they believe that the operating/trading activities and platform distinction set out in the rules is inappropriate for their specific business (SAICA, 2013:8).

SAICA is one of the advocates of principles-based accounting standards and this is reflected in the comment letters to the IASB on varying topics. For example, in 2011 the IASB issued a discussion document called *IASB's Request for views: Agenda Consultation 2011* requesting all the stakeholders to comment on what the IASB should include and exclude in their standard setting agenda items for the upcoming years. In response to this document, SAICA encouraged the IASB to continue to develop principles-based standards with a strong conceptual framework, which means that SAICA believes that principles-based accounting standards are superior to rules-based standards (SAICA, 2011:3). It would appear that by creating a rules-based headline earnings guidance, SAICA is in conflict with its overall objective of principles-based accounting standards, which it believes accounting guidance, should be based on.

The purpose of the financial statements preparation is to provide information that is useful to a wide range of users in assessing the financial performance, position and cash flows of the organisation (IASB, 2014:A36; Cudia & Manaligod, 2011:79). The rules contained in The Circular comprise general rules that apply to all JSE listed entities other than those that requested specific industry exclusion (SAICA, 2013). If a specific industry is of the view that a particular rule within the headline earnings formula is inappropriate for that industry, The Circular requires that the industry should make representation to the JSE on the matter (SAICA, 2013:21). The assumption is that all industries impacted by the general rule will make representation to the JSE to seek specific approval. If no representation is made, it could be assumed that the general rule meets the objective of providing financial information that is useful to the users of the financial statements, which may not necessarily be the case.

General rules are set out in a tabular format in The Circular and specifies whether each item of income or expense should be included or excluded in the calculation of headline earnings (SAICA, 2013:9-18). Special rules, on the other hand, are industry dependent and vary from one industry to another, based on that industry's representation to the JSE (SAICA, 2013:28-32).

It is questionable whether the current rules-based headline earnings guidance is helpful in comparing information across industries that are subjected to different rules specifically, when comparing those entities that are subjected to general rules, to those entities that are subjected to special rules. For example, the headline earnings guidance requires exclusion of investment property's fair value gains or losses from the headline earnings calculation of all entities (including property industry entities) other than life insurance industry entities (SAICA, 2013:17). Therefore, comparing the headline earnings of a life insurance industry entity to that of a property industry entity may prove to be a challenge, since a life insurance entity would have included the fair value gains or losses in the headline earnings calculation, whilst the property entity would have excluded the fair value gains or losses.

Similarly, in a conglomerate group where the group consists of entities subject to the general rule and the special rule, a question may be raised whether the group should calculate headline earnings based on both the general rule and the special rule, or should apply only the general rule for the consolidated financial statements.

Some studies have argued that it is not possible to create rules for all cases (Wüstemann & Wüstemann, 2010:3; Maines, Laureen, Bartov, Fairfield, Hirst, Lannaconi, Mallett, Schrand, Skinner & Vincent, 2003:74-75). Such studies argued that accounting standards should be based on principles rather than rules. In contrast, other studies that support a rules-based approach have argued that principles may be misused to achieve certain results, therefore that rules are less susceptible to manipulation than principles (Bailey & Sawers, 2012:27-28; Psaros & Trotman, 2004:77; Fischer & Stocken, 2004:243).

According to Bennett, Bradbury and Prangnell (2006:189), the Securities Exchange Commission (SEC) argued that the distinction between rules-based and principles-based accounting standards is not well defined, and is subject to a variety of interpretations. One interpretation is that principles-based accounting standards acknowledges professional judgement and provides limited guidance, whereas rules-based accounting standards contain numerous detailed rules, numerous exceptions, and voluminously detailed implementation guidance (McEnroe & Sullivan, 2012:33; Donelson, McInnis & Mergenthaler, 2012:1250; Jamal & Tan, 2010:1326; Benston, *et al,* 2006:165; Bennett, *et al,* 2006:191; Nelson, 2003:91; Nobes, 2005:26; Psaros & Trotman, 2004:78). This applies to The Circular, which provides detailed rules relating to items that should be included or excluded from the calculation of headline earnings. The consequence of this is that the headline earnings figure may comply in form to the JSE's listing requirements, but will not necessarily reflect the true and fair results of the entity.

Some studies (Cuzdriorean, Albu & Albu, 2012:60; Benston, *et al,* 2006:167 and Walker, 2007:54) argued that an overriding principle in standard setting should be the possibility of providing a true and fair reflection of an entity's results. Rules-based accounting standards reduce the use of judgement (Nobes, 2005:32). Studies indicated this approach to be a worthy one, since it offers the following advantages (Nelson, 2003:101; Nobes, 2005:32; Schipper, 2003:69):

- increased comparability between different entities;
- increased verifiability, which is likely to protect management and auditors, especially in the case of lawsuits resulting from corporate failures;
- reduced opportunities for earnings management through the use of judgement (but increased opportunities through structuring of transactions to achieve predetermined financial objective); and
- improved communication of standard-setters' intentions.

Others have argued that a rules-based approach is likely to result in vagueness in interpreting the meaning of some rules, which may result in some decisions not being described as either being wrong or right (Fornaro & Huang, 2012:204; Penno, 2008:339). Typically, this occurs in a rapidly changing environment that is likely to result in some rules becoming out-dated and therefore requiring revision. Such a revision of rules is evidenced in changes in the headline earnings guidance that is updated every time the IASB makes amendments, which have a direct impact on the specified rule.

Maines, *et al* (2003:74) argues that a principles-based approach to standard setting is more likely to reflect the economic substance of transactions than a rules-based approach. In addition, principles-based accounting standards are likely to provide relevant information, as management will be able to use judgement in applying the requirements. Some studies found that rules-based accounting standards are unlikely to meet the challenges of a complex and rapidly changing financial world, particularly since they provide the basis for compliance in form rather than in substance (Bailey & Sawers, 2012:28; Jamal & Tan, 2010:1326; Wüstemann & Wüstemann, 2010:1; Benston, *et al,* 2006:167).

1.1.2 Fair value

It has been a listing requirement since the year 2000 for all entities listed on the JSE, to disclose headline earnings (SAICA, 2013:4). As discussed above, one of the main uses of HEPS, is calculating a consistent P/E ratio, which can be used to compare entities' market ratings.

One of the criteria to be met before an item of income or expense is included in the headline earnings calculation, is that such an item of income or expense must have been determined as normally relating to the operating/trading activities of the entity or to the usage of a non-current asset, which is an operating/trading activity of the entity (SAICA, 2013:5). For example, expenses relating to the writing down of inventory to the lower of cost and net-realisable value is considered to be related to the normal operating activities of the entity, and would be included in the calculation of headline earnings (SAICA, 2013:13). Similarly, depreciation results from the normal usage of property, plant and equipment, and would be included in the headline earnings calculation (SAICA, 2013:14).

The term 'trading activity' is not defined in IFRS literature, but it is generally understood to mean the operating activity of the entity (IASB, 2014:A645). However, The Circular defines operating/trading activities as *"those activities that are carried out using the "platform", including the cost associated with financing those activities."* (SAICA, 2013:7). A platform is defined as *"the capital base of the entity. Capital transactions reflect and affect the resources committed in producing operating/trading performance and are not the performance itself."* (SAICA, 2013:7). In respect of the property industry entities, the underlying property represents the platform that is used to conduct the operating/trading activities (IASB, 2014:A1204; SAICA, 2013:7). The ordinary operating/trading activities of these entities involve either holding the properties for rental, or for the future growth in the property value (IASB, 2014:A1204; SAICA, 2013:7). Consequently, it can be argued that the fair value adjustments of the investment properties should be included as part of the headline earnings calculation.

In terms of IAS 40 *Investment Property*, an entity has an option to elect whether to account for an investment property using the cost model or the fair value model (IASB, 2014:A1208). Investment property is defined as property (land or building, or part of a building, or both) which is held for capital appreciation or for rental, or both (IASB, 2014:A1204). Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IASB, 2014:A1204).

This study excludes entities using the cost model, because these entities are unlikely to be impacted by the exclusion of fair value adjustments in headline earnings. However, there would be an impact on those entities using the fair value model by the exclusion of the fair value adjustments from the calculation of headline earnings, as per The Circular. IAS 40 does not require an entity to be trading with the property to adopt the fair value through profit or loss option. Instead, the only requirement is to demonstrate that the fair value can be measured reliably, and for the entity to choose the fair value option as its accounting policy for all its investment property (IASB, 2014:A1210).

The Circular takes different views in respect of whether the fair value gains or losses are included or excluded from the calculation of headline earnings. In order to illustrate this point, it is useful to compare the treatment of fair value gains or losses from financial instruments to those from investment property entities, and applying the definition of operating/trading activities as defined above, to both cases. The reason for the illustration below is to show the unintended consequences of two general rules contained in The Circular, which appears to be contradictory and inconsistent with the definition of operating/trading activities.

In terms of The Circular, the fair value measurements of financial instruments within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* are included in headline earnings (SAICA, 2013:12). However, the fair value measurement adjustment of investment property within the scope of IAS 40 *Investment Property* is excluded in determining headline earnings (SAICA, 2013:17). The results of these two general rules is, that two entities which are substantially the same, but differ in their investment strategies, are likely to reflect substantially different headline earnings. This point can be illustrated by considering an entity that invests all its capital in properties for capital appreciation and for rental purposes. Assume that in one financial year, there was no rental income due to a nil per cent occupancy ratio in that year, and that all the income reflected in that year was due to fair value gains. If the fair value gains were excluded from the calculation of headline earnings, the entity would show negative headline earnings for that period. Compare the results above to another entity, which has all its investments in the form of equity shares, which are classified at fair value through profit and loss. This entity would be able to include the fair value gains or losses in the headline earnings figure (equity investment entity) (SAICA, 2013:17). Consequently, it can be argued that if users of financial statements are to make investment decisions based solely on the headline earnings performance, they are likely to select the equity investment entity.

Applying the definition of operating/trading activities alone, without consideration for the specific rules contained in The Circular, one would have concluded that the ordinary activities of both entities is to invest their respective capital, one in properties and the other in equity investments. Therefore, properties and equity investments would respectively represent platforms for these entities. As a result, ordinarily one would have expected the fair value gains or losses of the two entities to be treated in the same way in the headline earnings calculation. This application would lead one to expect both fair value gains and losses to be included in the headline earnings based on the intended objective of the headline earnings guidance, which is to reflect the ordinary activity of an entity (SAICA, 2013:5). However, this is not the case.

Currently, The Circular has two exemptions to the general rules: One relating to the re-measurement of venture capitalist activities (also referred to as the private equity activities) of the banking industry. These activities are specifically included in the calculation of headline earnings. The second rule relates to the re-measurement of the investment property of the Listed Life Insurance entities that are also specifically included in the calculation of headline earnings (SAICA, 2013:30).

The Circular does not clearly establish principles for why industry specific rules are created for certain industry groups other than if there was a specific request by that industry group for such rules to be made (SAICA, 2013:21). Lack of clearly defined principles on the inclusion and exclusion of re-measurements is likely to result in conflicting concepts, and may not provide comparable information across different industries. In addition, it is less clear if the entities operating in a conglomerate are allowed to use more than one rule for each of the industry groups included in the consolidated financial statements.

Prior research revealed that preparers use the latitude in the accounting standards, regardless of whether those standards are principles-based accounting standards or rules-based, to manage earnings and support aggressive financial reporting (Bailey & Sawers, 2012:40; Jamal & Tan, 2010:1344). In the case of rules-based accounting standards, preparers of financial statements structure transactions around these rigid rules. On the other hand, judgement in principles-based accounting standards is applied to suit predetermined objectives (Bailey & Sawers, 2012:40). Furthermore, Jamal and Tan (2010:1344) argued that the type of accounting standard does not affect the preparers' choice to use aggressive financial reporting. In contrast, Agoglia, Doupnik and Tsakumis (2011:752) argued that less guidance increases the need to apply professional judgement consistent with the intent of the accounting standards. They argued that preparers are less likely to apply aggressive accounting treatment when applying principles-based accounting standards than when applying rules-based accounting standards (Agoglia, *et al,* 2011:764).

The aforementioned leads to the following problem statement.

1.2 PROBLEM STATEMENT

The research question of this study is as follows:

Is a rules-based approach or a principles-based approach more appropriate for the calculation of headline earnings of listed property entities on the JSE Limited for economic decision-making purposes?

1.3 SIGNIFICANCE AND RESEARCH OBJECTIVE

According to Stainbank and Harrod (2007:111) headline earnings is a popular performance measure number in South Africa. However, there are limited scholarly studies in this area. This study will fill the gap by analysing the framework within which the HEPS concept is based with a view to be able to conclude on the inappropriateness of rules-based guidance.

The objective of this research is to establish if headline earnings guidance should be rules-based or if it is more appropriate to have clearly defined principles. This study will further stimulate debate about the appropriateness of rules-based headline earnings guidance, and to add to the existing literature on the subject.

1.4 DELINEATIONS AND LIMITATIONS

The study is limited to the listed property entities and does not extend beyond these entities. This sector is referred to as the real estate investment and services sector of the Johannesburg Securities Exchange (JSE). The rest of the study uses the terms listed property entities and real estate investment and services entities interchangeably. The two terms refer to the same entities. In addition, it is not the purpose of the study to define the principles within which headline earnings should be based.

The study focuses on the entities listed on the main board of the JSE and will not include entities listed on Altx and Africa Boards.

1.5 RESEARCH DESIGN

Research design refers to the strategy adopted in conducting a research study (Strydom, 2013:150; Creswell, 2015:13). In assessing whether the rules-based approach to accounting standard setting is the most appropriate methodology, McEnroe and Sullivan (2012) used a survey of the auditors and chief financial officers (CFOs). A questionnaire with eleven questions based on the qualitative characteristics of preparing financial statements was prepared requesting participants to comment on the level of agreement to each statement. A questionnaire is defined as a form of structured interviewing, where all respondents are asked the same questions and are offered the same options in answering them (e.g. yes/no, ranked on a scale) (Hofstee, 2009:132). In this study, a similar approach is used.

1.5.1 Data collection

It was decided that the data collection procedure for this study would be survey questionnaires. In this research project, the software SurveyMonkey is used as a survey tool and therefore, the survey is internet-based. The focus was on the investment analysts and CFOs as the survey respondents. There are twenty-six listed properties industry entities on the JSE main board and sixty-one approved investment analysts. The respondents were sent an e-mail containing the URL link to the research project's questionnaire. They were informed of the timeframe during which the questionnaire should be completed and that the survey was anonymous. All entities and analysts were selected for the purpose of this study.

A questionnaire was prepared, requesting the participants to provide their level of agreement with the statements raised, to establish whether the participants believe headline earnings guidance should be rules-based or principles-based.

1.5.2 Data analysis

CFOs responses were analysed to evaluate if there is consensus in the basis for setting accounting standards (rules-based approach or principles-based approach) among preparers of financial statements. The same approach was followed to establish if investment analysts agree on the basis to be used for setting headline earnings guidance. The analysis was combined to assess if there is consensus from the responses. This analysis was the basis for concluding on the research question raised.

This research project follows a mixed-method approach, combining elements of both quantitative and qualitative aspects. Quantitative aspect means, that for each question raised, a conclusion was reached based on the higher percentage achieved between the responses supporting a rules-based approach, compared to responses supporting a principles-based approach. On the other hand, the qualitative aspect of this study involves interpreting the results in response to the research question.

1.6 STRUCTURE OF THE STUDY

Table 1.6.1 A visual summary of the study

The appropriateness of rules-based headline earnings guidance for listed property entities on the JSE Limited	
Chapter 1: Introduction	Chapter 2: Literature review
Chapter 3: Research design	Chapter 4: Research analysis
Chapter 5: Summary and conclusion	

1.6.1 Summary of the remaining chapters

The remaining chapters are organised as follows:

- **Chapter 2: Literature review**
  This chapter is the literature review focussing on the following: The history of headline earnings focussing specifically on why it was considered necessary to include headline earnings in the financial statements of South African entities, and why a rules-based approach was considered the most appropriate approach. This section discusses the dissenting views at the time of the first issue of the guidance for headline earnings

and the implication of the current guidance particularly relating to the principles-based versus rules-based debate.

The debate about principles-based versus rules-based is then expanded to include international literatures on the topic, particularly focussing on some lessons learnt from other jurisdictions such as the United States of America (USA).

Headline earnings and earnings per share impacts on the calculation of an entity's valuation particularly when a valuation method such as the price-earnings method is used. This section of chapter two focuses on the relevance of headline earnings when comparing a South African entity to an entity in another country, particularly given that South Africa is the only country where headline earnings is a listing requirement. In addition, this section will discuss the impact of earnings on the share price movements and earnings management.

- **Chapter 3: Research methodology**

  This chapter provides details of the research methodology applied in this study. In terms of The Circular, it is not clear what principle was used to exclude the fair value adjustments of investment properties of real estate investment and services entities, particularly given that their ordinary activity involves the renting out of properties, or the holding of the properties, for capital appreciation. In addition, it is not clear how the aforementioned rules should be applied to an entity in a conglomerate where both general and special provisions may apply.

  This chapter discusses the methods considered for this study and concludes that a survey-based study is more appropriate. There are twenty-six listed property industry entities and sixty-one approved investment analysts, all of which were selected for the purpose of this study. A questionnaire was prepared and sent to all the participants requesting them to state whether they agree, disagree, or are not sure about each of the statements raised.

- **Chapter 4: Results analysis**

  This chapter discusses the findings of the study and provides an analysis of the appropriateness of the rules-based headline earnings guidance for listed property entities.

  The total responses received were twenty-one from a combined population of eighty-seven, which equates to a twenty-four per cent response rate. The twenty-one responses comprised of six responses from the CFOs and fifteen from the investment analysts. There were twenty-six CFOs in total and sixty-one approved investment analysts, which means that the response rate for each population was twenty-three per cent and twenty-five per cent respectively. Due to the low response rate, this study follows a descriptive statistics method, which means that the researcher interpreted received responses to provide meaning for the results (Sandelowski, 2000:336).

  In summary, the results show that there is a preference for principles-based headline earnings guidance instead of rules-based guidance. In addition, the results show that principles-based headline earnings guidance is more likely to provide a relevant and faithful representation of the financial performance and position of an entity in the most cost effective way than rules-based headline earnings guidance.

- **Chapter 5: Summary and conclusion**

  This chapter summarises the study and provides a conclusion in respect of the research question. This chapter also provides suggestions for further studies.

  This study adds to the current limited literature and raises the debate on the appropriateness of rules-based headline earnings guidance. Given the necessity of reporting the headline earnings in South Africa, there is a need for further studies in this area. Further studies may include defining the principles within which the calculation of headline earnings should be based. This area is not specifically dealt with in this study.

  The population in this study included the CFOs of investment property entities and investment analysts, which means that future studies may focus on the auditors or CFOs of other sectors.

Given that South Africa is the only country where the disclosure of headline earnings is a listing requirement, there is scope for future studies focussing on the relevance of headline earnings in the global context particularly given the IASB's harmonisation of accounting standards project. The harmonisation project aims to ensure that all countries apply the IFRS accounting standards in the preparation of the annual financial statements.

Chapter 2: Literature Review

2.1 INTRODUCTION

When headline earnings guidance was first issued as an accounting standard in 1995, not everyone agreed with the purpose of its issue and the objective the guidance aimed to achieve. Although headline earnings are not representative of maintainable earnings, concerns were raised that some users of the financial statements would perceive it to be reflective of sustainable earnings. In fact subsequent studies revealed that more than seventy-three per cent of the users of the financial statements believe that headline earnings represent maintainable or sustainable earnings, which it does not (Stainbank & Harrod, 2007:100).

The rest of the chapter is set out as follows: The first section discusses the history of the headline earnings concept, exploring some of the reservations raised in the first issue of the guidance and how it impacts on the current rules-based guidance, as well as the implications of the perception around what headline earnings is perceived to represent versus the intention of the headline earnings concept. The second part of the chapter discusses the rules-based approach versus the principles-based approach, focussing on the advantages and disadvantages of each approach, with emphasis on lessons learnt from other jurisdictions such as the United States of America. The third part discusses the equity valuation whereby the impact of using earnings per share (EPS) or headline earnings per share (HEPS) in calculating the price-earnings (P/E) ratio is explored. The fourth part of the chapter discusses the qualitative characteristics based on the new conceptual framework, which was established as a joint project between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB). This section also provides a status update of the revised conceptual framework project with a particular emphasis on the implication of qualitative characteristics on the rules-based versus principles-based accounting standards debate.

The fifth part discusses the historical cost method versus the fair value option included in the accounting standard IAS 40 *Investment Property*. The discussion is expanded to include the impact of IFRS 13 *Fair Value Measurements*. Specifically, this section discusses how the new definition of fair value affects the fair value gains or losses of investment properties.

There is mixed evidence about whether principles-based accounting standards are more easily manipulated than rules-based accounting standards. Some scholars believe that rules-based accounting standards encourage preparers of the financial statements to structure their transactions around these rules (Donelson, *et al,* 2012:1273; Jamal & Tan, 2010:1344). The sixth part of this chapter discusses earnings manipulation (also referred to as earnings management) with a particular focus on the impact on headline earnings. The seventh part discusses the link between ethics and earnings management. The eighth part, the study discusses the influence that the auditors have on both the standard-setting process as well as the interpretation of the principles contained in the accounting standards. In addition, auditors are tasked with expressing an opinion on whether the financial statements are a true and fair reflection of the entity's performance and financial position. Finally, the study discusses the decision-usefulness theory, focussing specifically on whether headline earnings provide information that is useful to the users of the financial statements in making their economic decisions.

2.2 HISTORY OF HEADLINE EARNINGS IN SOUTH AFRICA

In order to understand the headline earnings it is helpful to look at the history of the concept to understand the origin of the headline earnings guidance, and to understand what the objective of the guidance was in its first issue. The section that follows aims to achieve this objective.

Headline earnings guidance was first issued in South Africa in November 1995 in the form of AC 306 *Headline Earnings – The Effect of the Issue of AC 103 (Revised) on the Calculation and Disclosure of Earnings per Share* in response to the issue of the revised AC 103 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* (SAICA, 1995:1).

In terms of AC 103 the profit for the year was categorised into two parts, the first part being the income or expenses resulting from the ordinary operating activities of the entity and the second part resulting from the extraordinary items (also referred to as capital items). Extraordinary items were defined as those activities that did not form part of the ordinary activities of an entity; examples included profit or loss on disposal of property, plant and equipment and profit or loss on disposal of investments (SAICA, 1995:5).

The revised AC 103 (revised in 1995) resulted in a narrower definition of ‘extraordinary items’, which had the effect that some items previously classified as extraordinary items, were included in the entity’s performance (SAICA, 1995:1). The consequence of this amendment was that the earnings were likely to be more volatile than before the issue of the revised AC 103 due to the inclusion of some extraordinary items in the entity's trading performance figure. Therefore, it was concluded that the volatility in earnings may not provide users with the information they needed to assess the operating performance of the entity (SAICA, 1995:1). This resulted in the introduction of headline earnings guidance (SAICA, 1995).

It is important to note that in 1995, there was no international guidance on the earnings per share calculation. IAS 33 *Earnings Per Share* was only issued for the first time in February 1997 by the International Accounting Standards Committee (IASC), the IASB’s predecessor body (IASB, 2014: A995). IAS 33 was issued for the first time in South Africa in March 2004, with the effective date being for the year beginning on or after 1 January 2005, that is a decade after the issue of the revised AC 103. This means that headline earnings guidance was first issued in South Africa, when there was no internationally accepted guidance on earnings per share.

In South Africa, the Accounting Issues Task Force (AITF) was established in 1995 to investigate the issue. The AITF established the headline earnings concept from the Institute of Investment Management and Research (IIMR) in the United Kingdom (SAICA, 1995:2). The IIMR’s objective was to establish a standardised basis of determining trading performance earnings (not necessarily maintainable earnings) by excluding capital-related items such as profit or loss on sale of fixed assets, sale of businesses, goodwill and all extraordinary items amongst other things (SAICA, 1995:3-5).

The timeline for headline earnings guidance can be summarised as follows:

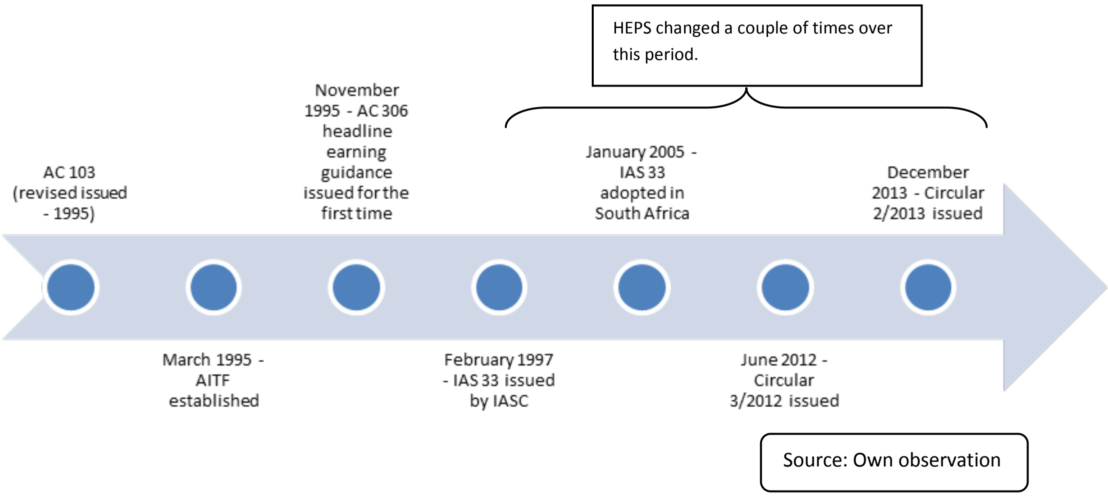

Figure 2.1 Timeline for headline earnings guidance

When headline earnings guidance (AC 306) was first proposed, not every stakeholder agreed with its issue. For example, Ernst and Young objected on the following grounds (Ernst and Young, 1996:3) and argued that:

- the calculation is a mechanical exercise and follows an arbitrary set of rules;
- the exclusion of capital items in the calculation of headline earnings is misleading in calculating an entity's performance;
- the calculation of headline earnings per share promotes reliance on a one-figure earnings per share, rather than encouraging users of financial statements to understand the effects of management's decisions;
- headline earnings guidance undermines the EPS calculation in terms of AC 104 Earnings Per Share (i.e. the equivalent of the current IAS 33); and
- users could mistakenly believe that headline earnings per share is a sustainable or maintainable EPS when it is not necessarily an indication of this.

The Circular was issued regardless of any reservations that stakeholders may have had.

Headline earnings guidance has evolved since its first issue in 1995 in the form of AC 306 up until the current Circular 2/2013. Even though there have been a number of changes to the guidance, the same arguments as raised by Ernst and Young in 1996 can still be made about the current guidance. The Circular includes a number of arbitrarily set rules, which at times result in transactions that are economically similar, being treated differently (SAICA, 2013:6). In certain circumstances, compliance with the set rules results in conformity in form rather than providing useful information.

The Circular, unlike AC 306, does not refer to capital items. However, The Circular refers to included and excluded measurement. Included measurements are those measurements that are included in the calculation of headline earnings, which are typically those measurement items relating to the ordinary operations of an entity such as the write-down of inventory to its net realisable value in terms of IAS 2 *Inventories* (SAICA, 2013:13). Excluded measurements are those that are not related to the operating activities such as profit or loss on sale of property in terms of IAS 16 *Property, Plant and Equipment* (SAICA, 2013:14). A detailed discussion of this is included in section 2.4.1 of this chapter.

Prior to the introduction of an international accounting standard on earnings per share, headline earnings guidance was introduced in South Africa through the issue of AC 306 *Headline Earnings – The Effect of the Issue of AC 103 (revised) on the Calculation and Disclosure of Earnings Per Share*, issued in November 1995. There is an international standard at present in the form of IAS 33. The Circular states that the issue of the headline earnings guidance should not be viewed as diverging from IFRS, instead it should be viewed as reflecting earnings from operating/trading activities and excluding gains or losses from platforms used to generate these operating/trading activities (SAICA, 2013:7). However, given that the IASB has issued guidance on earnings per share, having a South African specific earnings per share calculation, in the form of The Circular on headline earnings per share may be perceived to undermine the IASB’s effort for convergence in accounting standards around the globe. In contrast, IAS 33 allows the inclusion of other per share measurements not prescribed by the accounting standard, as long as those measures do not conflict with the requirements of the standard (IASB, 2014:A1013). The Circular requirements do not conflict with the requirements of IAS 33 (SAICA, 2013:5). Instead, the requirements of The Circular supplement the IASB's earnings per share. Therefore, it can be argued that The Circular is consistent with the requirements of IAS 33.

2.3 RULES VERSUS PRINCIPLES

Accounting standards continue to change reflecting the very notion of accounting being one of the social sciences; it evolves as society changes driven by changes in the economic, political and religious environment (Alwan, 2012:998). The global economic recession of 2008 resulted in questions being raised about the appropriateness of the guidance on financial instruments in the form of IAS 39 *Financial Instruments: Recognition and Measurement.* Some believe that the guidance on financial instruments was too complicated and contained rules, which at times were contradictory (IASB, 2014:A536). Other stakeholders questioned the appropriateness of the impairment model of financial instruments, which requires that there needs to be objective evidence of impairment before a financial instrument is written down (IASB, 2014:A1160). Some held that this model is reactive rather than proactive, particularly given that this model ignores early warnings that are not objective assessments (IASB, 2014:A1161). It was recommended that the IASB revisited the financial instrument guidance with an emphasis on principles guidance (IASB, 2014:A308). The IASB responded by introducing IFRS 9 *Financial Instruments*, which has been introduced in phases to replace IAS 39. Changes in the IFRS standards also mean that SAICA needs to review the guidance on the calculation of headline earnings.

So far, changes in the financial instruments guidance did not change the included and excluded re-measurement items in terms of headline earnings guidance. Fair value gains or losses from financial instruments are still included in the headline earnings calculation (SAICA, 2013:17). However, fair value gains or losses from investment property are excluded from the headline earnings calculation (SAICA, 2013:17). Similarly, impairment losses are excluded from the headline earnings calculation for all investment properties measured at historical cost (SAICA, 2013:16).

The section that follows discusses the distinction between rules-based accounting standards and principles-based accounting standards.

2.3.1 Distinction between rules-based and principles-based accounting standards

Scholars differentiate between principles-based accounting standards and rules-based accounting standards, based on the degree of the level of specification (Wüstemann & Wüstemann, 2010:21). Principles are generally believed to be high-level guidance, without detailed specification of what to do in different circumstances (Wüstemann & Wüstemann, 2010:21). Based on this high-level guidance, preparers of financial statements are expected to make decisions about what the best accounting treatments would be for different scenarios. Rules, on the other hand, are aimed at limiting the options by providing a specific prescription of what to do in different circumstances (Wüstemann & Wüstemann, 2010:21; McEnroe & Sullivan, 2012:33; Donelson, *et al*, 2012:1273; Jamal & Tan, 2010:1344; Benston, *et al,* 2006:165; Bennett, *et al,* 2006:189; Nelson, 2003:101; Nobes, 2005:32; Psaros & Trotman, 2004:91).

Rules-based accounting standards assume that the specified rules will apply equally to all circumstances that entities are faced with, including those unforeseen. However, in a rapidly changing environment, a rules-based approach is likely to fall short, particularly because new challenges require new solutions which may not have been foreseen when the rules were created (Penno, 2008:339). The global economic crisis of 2008 raised the question of whether principles-based accounting standards are superior to the rules-based accounting standards, particularly given that principles-based accounting standards encourage the use of judgement (Alwan, 2012:998).

IFRS statements are largely principles-based which makes them open for interpretation. Although other scholars have criticised this approach in favour of a rules-based approach, some believe that over time, principles-based accounting standards are far more likely to result in the consistent application of accounting standards than a rules-based approach (Agoglia, *et al,* 2011:752). Principles-based accounting standards do not aim to address all the specific scenarios, but to provide principles that can be applied in any situation. This means that those principles are adaptive to a changing environment and can be modified and applied to the circumstances based on the facts presented. The supporters of principles-based accounting standards also argue that it is not possible to create rules to cover all possible situations (Agoglia, *et al,* 2011:749). Therefore, principles-based accounting standards are viewed as being superior to rules-based accounting standards.

Others hold the view that the distinction between rules-based accounting standards and principles-based accounting standards is not well defined and are subject to a variety of interpretations (Bennet, *et al,* 2006:189; Donelson, *et al,* 2012:1273). One interpretation is that principles-based accounting standards contain a clear statement of intent, but lacks detailed guidance, whereas rules-based accounting standards include detailed implementation guidance and compliance rules (Collins, Pasewark, & Riley, 2012:702; Sepehri & Houmes, 2011:59).

Illiano (2012:26) argued that the debate of whether the United States of America's Generally Accepted Accounting Principles (US GAAP) are rules-based accounting standards and that IFRS are principles-based accounting standards, typically suggests that the two standards can only be classified as either rules-based or principles-based. Although US GAAP contains more guidance than IFRS, it does not preclude it from being principles-based (Illiano, 2012:26). Similarly, IFRS includes some implementation guidance in other accounting standards (such as IAS 39) which may be argued to constitute rules-based guidance. However, the extent of the guidance provided is what differentiates the accounting standards from being either principles-based or rules-based. This means that if an accounting standard includes detailed explanations and exceptions, it is likely that such an accounting standard would be considered to be a rules-based accounting standard.

It is important to highlight that the users of the financial statements are not necessarily able to distinguish whether the financial statements have been prepared based on accounting standards that are principles-based or rules-based accounting standards when reading a set of financial statements (Bailey & Sawers, 2012:26). Decisions on whether The Circular on headline earnings should be principles-based or rules-based, requires each approach to be evaluated on its own merit in relation to the decision-usefulness of the information provided by such an approach, considering the underlying qualitative characteristics of providing financial information (IASB, 2014). Qualitative characteristics are discussed in section 2.5 below.

2.3.2 Guidance requirement

In certain instances, accounting standards are developed and issued as principles-based accounting standards, however, over time, practitioners (be it auditors or preparers) demand guidance to clarify ambiguity or perceived ambiguity within the accounting standard (Agoglia, *et al,* 2011:751). Such requests typically arise in cases where different professionals, be it the auditor and their clients, interpret concepts differently (Penno, 2008:339). Over time, additional clarification and the inclusion of exceptions contributes to the creation of accounting standards that are to a degree, rules-based.

An example of this would be the introduction of IAS 39 *Financial Instruments: Recognition and Measurement.* It was largely principles-based when the accounting standard was first introduced, but the inclusion of guidance over time has resulted in a number of rules, which at times are inconsistent from one accounting standard to another, and sometimes result in conflicting rules within one accounting standard (IASB, 2014:A536). During the 2008 economic crisis, this raised the question of whether accounting standards (financial instruments and fair value measurement in particular) contributed to the financial crisis (Alwan, 2012:998; IASB, 2014:A308).

Prior to the introduction of IFRS 13 *Fair Value Measurement*, there were inconsistencies about the application guidance of fair value in various accounting standards. In response to this, the IASB issued IFRS 13 to consolidate the fair value concept. IFRS 13 deals with the measurement of fair values and provides a consistent measure across different IFRS standards, which is discussed in detail in section 2.6. If principles-based accounting standards are to remain as such, this will require practitioners to accept that they may not have consensus on all topics. Such disagreements should not be viewed as undermining the usefulness of financial information, as long as the intent remains the reporting of an unbiased, true and fair view (economic reality) of the results.

2.3.3 The situation in the USA

It remains debatable whether a rules-based accounting standard provides more relevant information than a principles-based accounting standard. The global economic crisis, which started in 2008, resulted in an increased debate regarding which accounting standards are better, particularly in the wake of corporate failures such as Lehman Brothers, mortgage originators such as Fannie Mae and Freddie Mac, and Ginnie Mae amongst others (Agoglia, *et al,* 2011:748). In the same year (2008), the Securities Exchange Commission (SEC) issued the IFRS adoption roadmap, which required all the entities in the USA to apply IFRS by 2014 (McEnroe & Sullivan, 2012:32). After the issue of the roadmap, there have been a number of discussions about how it should be implemented, whether US GAAP should converge with IFRS or whether USA entities need to adopt IFRS as their accounting standards.

The history of the convergence of accounting standards can be traced back to as early as the end of World War II as part of the global reform (Lam, 2015:7). At that time, entities that operated in a number of countries wanted standardised financial reporting across the different countries in which they operated (Lam, 2015:7). It is this same need that encouraged the IASB and the predecessor bodies such as the IASC to commit to the harmonisation of the accounting standards across the globe (Lam, 2015:7). IFRS is now widely used by a number of countries across the globe, other than in a few such as the

USA, Japan, Russia and India, to name but a few. It is believed that the adoption of IFRS by the USA is likely to encourage the rest of the countries who are currently not applying IFRS to also adopt (Lam, 2015: 5).

Since the global economic crisis, the IASB and FASB have been working together on a number of projects including the revision of the Conceptual Framework, IFRS 9, IFRS 13, amendments to IAS 32 *Financial Instruments: Presentation*, to name but a few. The outcome of these projects reduces the gap between the IASB's IFRS 9 and FASB's equivalent standard on financial instruments, but does not eliminate the differences particularly in the application guidance (Agoglia, *et al,* 2011:765).

In the original Memorandum of Understanding (MoU) between the IASB and FASB issued in 2006, the two accounting standards setting bodies had committed to have a common set of principles-based accounting standards by 2008 (Lam, 2015:61). On 21 December 2007, the USA issued rules allowing the use of IFRS accounting standards in place of US GAAP for all foreign private issuers of financial statements. The use of IFRS accounting standards was effective from 4 March 2008. This means that for foreign private issuers of financial statements, the requirement to prepare reconciliations between the financial statements prepared according to IFRS and those prepared according to US GAAP was no longer necessary. In September 2008, the USA updated the MoU to reflect the progress made since 2006 (limited progress was made) and moved the convergence deadline from 2008 to 2011 (Lam, 2015:61).

The latest update to the MoU was made in 2011 when the FASB extended the timeline for the convergence, but without committing to a deadline (Lam, 2015:61). Lack of commitment to a timeline coupled with the fact that previous timelines have been missed raises doubts about the likely success of the convergence project. In addition, the fact that some of the projects between the IASB and FASB which were established as joint projects are now being completed by each board separately raises doubts whether the two boards are still committed to the convergence project. For example, the Conceptual Framework was initiated as a joint project and now the IASB is completing this project separately from the FASB, which means that the original objective to create common high quality standards may not be achieved (Lam, 2015:20). Some of the joint projects have similar principles, but differ slightly in words and the level of detail guidance.

An example of this is the recent joint project between FASB and the IASB on revenue recognition, which aims to eliminate the more than 200 US GAAP revenue recognition standards and replace them with one accounting standard, which will clearly articulate the principles to be applied to all revenue transactions regardless of the industry (Illiano, 2012:27; Sedki, Smith & Strickland, 2014:121).

Bailey and Sawers (2012:26) argued that endorsing a principles-based accounting standard assumes that principles-based accounting standards improve the quality and transparency of financial information as well as user decision-making. Rules-based accounting standards are interpreted as enforcing compliance at the expense of reflecting the economic substance of the transaction (Sepehri & Houmes, 2011:54).

The collapse of Enron and Arthur Andersen in the USA is a perfect example of compliance in form, but without complying with the intent and spirit of the accounting standard (Aßländer, 2005:71). Arthur Andersen was the auditors of Enron and was responsible for expressing an opinion on whether the financial results of Enron reflected the true and fair economic performance of the entity (Aßländer, 2005:71). From an external stakeholders' perspective, there was an expectation that Arthur Andersen would act independently of Enron's management and objectively attest to the financial state of affairs. However, the failure of Enron raised questions about the independence of the auditors, particularly given that the recognition of some of the transactions did not reflect the economic reality of the transactions (Aßländer, 2005:72). In addition, Aßländer (2005)'s study raised questions about the adequacy of the USA rules-based guidance and its appropriateness in addressing earnings management.

One of Enron's earnings management schemes involved the structuring of special purpose vehicles that resulted in off-balance sheet liabilities, which were not brought to the attention of users of the financial statements. These schemes were set out as follows: Enron entered into a number of structured finance transactions, which in part involved smoothing their profits and reflecting a better financial position than was in fact the case. Enron would enter into fictitious transactions either with an entity established by Enron specifically for this purpose (also referred to as a special purpose vehicle), or an entity owned by one of Enron's subsidiaries, to deliver oil or gas in the future for immediate payment (Aßländer, 2005:64). The intention of entering into these transactions was never to deliver gas or oil, but to raise cash for Enron, without reflecting the liability on the statement of financial position. The prepaid forward contract would then be hedged by Enron's share price (Aßländer, 2005:64). As long as the share price increased steadily, Enron could raise its cash flow without entering any debt in its statement of financial position. The increase in the share price also meant that Enron could reflect a better financial position whilst distorting the true and fair view of the entity's solvency. However, when the share price markets stagnated, the Enron system collapsed (Aßländer, 2005:72). The collapse in the share price meant that Enron could no longer afford to raise cash flow and was unable to meet its liabilities. As a result, Enron then filed for insolvency.

Some studies have suggested that a move toward a principles-based system would provide management with too much flexibility and auditors with too little guidance (Lam, 2015:6), while others have suggested that a principles-based system, at least under certain circumstances, may reduce "aggressive" accounting practices (McEnroe and Sullivan, 2012:33). However, accounting practices are directly linked to ethical behaviours of the preparers rather than the type of accounting standards (Davidson & Stevens, 2013:71). This suggests that there is no correlation between misrepresentation in the financial statements, which can also be referred to as earnings management, and whether the financial statements were prepared using principles-based or rules-based accounting standards, but is rather dependent on the morality of the preparers of the financial statements. Earnings management and ethics are discussed in detail in sections 2.7 and 2.8 respectively.

There is evidence that suggests that principles-based accounting standards result in increased litigation because of an increased use of judgements (Donelson, *et al*, 2012:1273). However, the use of judgement does not result in the outcome being dismissed as an intentional misrepresentation of the facts. Rather, it was found that the use of judgement by well-trained professionals is likely to result in cases being dismissed at an early stage due to the differences in judgement being classified as a difference in opinion, rather than a misrepresentation of facts (Illiano, 2012:27; Donelson, *et al,* 2012:1273).

In the case of *Fait v. Regions Financial*, the court ruled that for judgement to constitute a material misrepresentation or omission in a registration statement, those opinions must be objectively false and not be believed by the person making the statement at the time (Illiano, 2012:27). This ruling emphasises that differences in professional judgement does not result in financial information being less useful. The same cannot be said about the rules-based accounting standard, which reduces the application of professional judgement and requires preparers of financial statements to comply with stated rules (Illiano, 2012:27). Consequently, decisions are not made based on opinion, but based on factual specified requirements as stated in the accounting standard.

2.3.4 Limiting alternatives

Some IFRS accounting standards provide options within the standard that allow preparers of financial statements to select one option as an accounting policy for an entity. For example, in terms of IAS 40, preparers of the financial statements have a choice between the historical cost model and the fair value model in accounting for investment property (IASB, 2014:A1208). Wüstemann and Wüstemann (2010:3) argued that limiting options within accounting standards is likely to increase the comparability of financial results between two or more entities.

The statement of profit or loss and other comprehensive income prepared using the historical cost model is not comparable to that of an entity using the fair value model for investment property, particularly when such a property was purchased a long time ago. This is because the fair value model reflects the latest prices and the buying or selling price of the property at a particular point in time, while historical cost is based on the amount that the property was originally acquired for. In contrast, the requirement to disclose fair values in the notes to the financial statements is likely to help users of the financial statements adjust the statement of profit or loss and other comprehensive income in order to make the statement of profit or loss and other comprehensive income of the two entities comparable (IASB, 2014:1215).

Consistency in the application of the accounting standards can only be achieved if the accounting standards are internally consistent (Wüstemann & Wüstemann, 2010:3). In the context of the existing headline earnings guidance (i.e. The Circular), the inclusion of both a general rule as well as industry specific rules may be perceived to be internally inconsistent within the accounting guidance, which results in substantially similar transactions being accounted for differently, depending on whether the general rule or an industry specific rule is being applied.

Alexander and Jermakowicz (2006:161) argued that internal consistency within the accounting standards is not possible, given that accounting is not a science. Thus, accounting decisions cannot be described as being either right or wrong. Instead, management is expected to make judgements based on the best available information at the time.

2.3.5 Summary and conclusion

The above discussion explored the debate between a principles-based and a rules-based approach. The literature suggests that generally, principles-based accounting standards are more likely to be adaptive to change. Consequently, preparers are allowed to interpret the facts presented based on the principles established in the accounting standard rather than ensuring compliance with stated rules. Therefore, questions may be raised about the appropriateness of rules-based headline earnings guidance, particularly given that SAICA is in agreement with the IASB in setting principles-based accounting standards. In addition, the SEC also acknowledges the weaknesses of the rules-based approach and intends moving to principles-based accounting standards. One of these weaknesses includes the need for detailed guidance, which at times, instead of clarifying the intended objective of the accounting standard, results in conflicting rules within the same accounting standard. In other instances these rules result in transactions, which are fundamentally the same, but are treated differently because of the different options provided in the different accounting standards.

Given that the principles-based approach is flexible and adaptive to different situations it can be argued that The Circular should be principles-based rather than rules-based. In addition, given that SAICA is one of the proponents of principles-based accounting standards, one would expect that any accounting guidance they develop would be principles-based (SAICA, 2011:3). Failure to develop principles-based headline earnings guidance may be interpreted as SAICA being in contradiction with its overall objective of applying principles-based accounting standards.

2.4 EQUITY VALUATION

The valuation of an entity's equity encompasses both financial and non-financial performance measures (Ndlovu, 2010:1). Financial measures typically include headline earnings per share, earnings per share, return on investments and share prices. Non-financial measures include an entity's contribution towards the well-being of society and productivity (Domanović & Bogićević, 2009:113). Non-financial measures, unlike financial measures, are not always disclosed in the financial statements. In fact, no IFRS accounting standards require disclosure of non-financial measures. The discussion below is limited to the financial measures only, with specific focus on P/E ratio as a measure of an entity's value. A detailed discussion of non-financial measures is beyond the scope of this study.

2.4.1 Price-earnings valuation

The calculation of the headline earnings figure affects the valuation of the equity of an entity, particularly when a valuation methodology such as a price-earnings (P/E) ratio is used (Menaje & Placido, 2012:36; Malik, 2011:136). P/E is defined as the current market share price of an entity divided by the earnings.

It is important to understand which earnings number is used in the calculation of the P/E ratio. In the South African context, the earnings can be in terms of IAS 33 or headline earnings as per The Circular.

The earnings figure used in the P/E ratio is defined in terms of IAS 33 as the profit or loss attributable to ordinary equity holders of the parent entity (IASB, 2014:A1001). In terms of The Circular, headline earnings is calculated by taking the earnings determined in terms of IAS 33 as described above and performing adjustments for re-measurements based on the rules stipulated in The Circular (SAICA, 2013:5).

A re-measurement is an amount recognised in profit or loss relating to any change (whether realised or unrealised) in the carrying amount of an asset or liability that arose after the initial recognition of such an asset or liability (SAICA, 2013:6). Consequently, fair value adjustments on subsequent recognition of investment property would constitute a re-measurement as defined. Re-measurements are either classified as being included re-measurements, or excluded re-measurements. Included re-measurements are either specifically required in terms of the specified rules, or fall within any of the categories listed below:

"i. they have been determined as normally relating to the operating/trading activities of the entity;

- *they relate to the usage (as reflected by depreciation) of a non-current asset, which is an operating/trading activity of the entity;*
- *they relate to current assets or current liabilities, and thus relate to the operating/trading activities of the entity (other than current assets or liabilities as part of a disposal group within the measurement scope of IFRS 5 − Non-current Assets Held for Sale and Discontinued Operations);*
- *they are foreign exchange movements on monetary assets and liabilities and thus relate to the operating/trading activities of the entity, except for those relating to foreign operations that were previously recognised in other comprehensive income and subsequently*

reclassified to profit or loss. This exception also applies to the translation differences of loans or receivables that form part of such net investment in a foreign operation;

- *they are financial instrument adjustments arising from the application of IAS 39 (whether as the result of revaluation, impairment or amortisation), except for all reclassified gains and losses..... For example, gains or losses on available-for-sale financial assets that are reclassified to profit or loss on disposal or impairment of the financial asset are excluded from headline earnings because the reclassified fair value gains and losses do not only reflect performance in the current period; or*
- *they are reclassified items relating to IAS 39 cash-flow hedges because these amounts are matched with those relating to the hedged item." (SAICA 2013:6)*

The result is that headline earnings per share calculated based on The Circular is not comparable to the EPS calculated based on IAS 33. The use of the P/E ratio to compare the valuation of a South African based entity to its international counterparts requires caution, and should raise questions about how the earnings number is defined to ensure that the P/E ratio is calculated on a consistent basis.

A question may be raised as to the relevance of The Circular in an international context, particularly given that South Africa is the only country where headline earnings is a listing requirement. The introduction of IAS 33 by the IASB was to achieve international harmonisation in the calculation of EPS (Seetharaman & Raj, 2011:118). The continuing use of The Circular may be perceived as being contrary to the harmonisation objective.

2.4.2 Factors influencing the share price

No studies have been done in South Africa to determine the impact of headline earnings on the share price of an entity. However, a number of studies have been done elsewhere, where it was found that there is a direct correlation between earnings and share price (Chan, *et al,* 2006:1076). Consequently, the higher the earnings figure, the greater the demand for the share, which increases the share price and results in an increase in the market value of the equity of the entity (Pushpa & Sumangala, 2012:1).

Menaje and Placido (2012:36) and Jordan, Clark and Smith (2007:343), who found that EPS is a key driver of the share price, reached a similar conclusion. The conclusion being that the impact of earnings on the demand and supply of shares indicates the importance of financial information in helping users of financial statements make the appropriate decisions on whether to buy or sell shares. Investors seek financial information that has significant impact on the share price (Menaje and Placido, 2012:35). This concept is also referred to as decision usefulness information and is discussed in detail in section 2.10.

Some researchers also found that EPS directly affects the market value of an entity (Rashty & O'Shaughnessy, 2011:40; Pushpa & Sumangala 2012:1; Malik, 2011:136). According to Jordan, *et al* (2007:343), some researchers have even suggested that EPS can also be indicative of the long-term cash flows of an entity.

Menaje and Placido (2012:35) found that a single measure may not be enough when analysing the share price; thereby supporting the IASB's view that there is no single number that encapsulates the performance of an entity (SAICA, 2013:4). Users are expected to consider the set of financial statements in its entirety before making a decision and not to make decisions based only on the EPS/HEPS figure (SAICA, 2013:5). EPS/HEPS is a reflection of the entity's performance for the financial year and does not take into account factors that may influence the entity's future performance such as investment decisions made in that year (IASB, 2014:A1001). This could be illustrated as follows: An entity may have disposed of property, plant and equipment that significantly reduced the depreciation charge in that year, resulting in higher earnings for the year. Consequently, only using the earnings to evaluate performance ignores the fact that the entity does not have the machinery required to produce materials in the future, or that the entity may have to incur higher machinery rentals in the future in place of the machinery sold. Consequently, earnings per share can be argued to be a short-term performance measure rather than a long-term one.

If accounting information is useful in making economic decisions, changes in such information must result in changes in the share price movement (Malik, 2011:141; Menaje & Placido, 2012:59). This view suggests that the share price movement is not only attributable to the earnings per share, but is reflective of the overall financial performance of an entity. Using the same example as above, if an entity sold its machinery and leased it back or leased another one at a higher rental, this is likely to reduce the entity's future earnings. Therefore, it can be argued that this should result in a decrease in the share price. The resulting valuation of an entity using the P/E ratio will provide a comprehensive view which takes into account decisions which have both short-term and long-term consequences (Menaje & Placido, 2012:59).

According to a survey conducted by SAICA in 2006, there is a demand for an alternative number to EPS and this could be the P/E ratio calculated by using the headline earnings number. The current share price used in the calculation of the P/E ratio represents a number of years' earnings calculated on a consistent basis (SAICA, 2013:5). It is believed that the aforementioned P/E ratio better reflects the entity's value than if the earnings are calculated in terms of IAS 33 which fails to consider those once-off non-recurring capital items, also referred to as excluded re-measurement items (SAICA, 2015:5). The discussion of included and excluded re-measurement items is covered in detail in section 2.4.1 above.

It is important to highlight the causes for the movements to comprehend the share price movements. The causes for the movements are based on the economic fundamentals of supply and demand (Menaje & Placido, 2012:41). In a perfect market, this means that both the sellers and buyers have the same financial information, which is relevant in making their economic decisions and their intention is to maximise returns (Menaje & Placido, 2012:41). The reason for the high supply and demand of certain shares is largely based on how investors perceive the future performance of the entity.

2.4.3 Summary and conclusion

There are a number of other performance indicators or methods used to determine the entity's value or the value created during the period, which are not discussed in this study, which are worth noting. For example, financial performance measures such as return on investment, and non-financial performance measures such as contributing towards the well-being of society and productivity. The basis for determining headline earnings affects the calculation of the P/E ratio. The P/E ratio helps users of the financial statements assess the value of an entity to be able to compare one entity to another. This means that if the earnings are not calculated in a consistent manner between the different entities, such a comparison may not be meaningful. For example, this would be the case if one entity's earnings are calculated using IAS 33 and another entity uses headline earnings as per The Circular. It is debatable whether there is a need for guidance on headline earnings. This will ensure consistency between South Africa and the rest of the world, particularly given that South Africa is the only country where headline earnings is a listing requirement.

Headline earnings may not capture some of the long-term financial consequences of management's decisions made during the financial year especially if the impact is not reflected in the current year's financial results. However, studies show that in a fair market such an impact is likely to be reflected in the share price (Malik, 2011:141; Menaje & Placido, 2012:59). As a result, the valuation of an entity using a P/E ratio is likely to take into account the impact of decisions reflected in the earnings of the current year and the impact of those decisions on the long-term view of the entity.

The distinction between re-measurements which are included or those excluded in the calculation of headline earnings is not well defined and at times seems contradictory, which necessitates the need for industry specific rules. If there are clearly defined principles for what are included and what are excluded re-measurements it will eliminate the need for industry specific rules. However, this is likely to require that the preparers of financial statements are afforded the opportunity to use professional judgement in determining what is to be included or excluded from the calculation of headline earnings.

2.5 QUALITATIVE CHARACTERISTICS

The IASB and FASB initiated a joint project to revise the conceptual framework, which is now being completed by each board separately. This project is conducted in phases and on completion of each phase the framework is updated to reflect the new section (IASB, 2014:A19). Eventually, the *Framework for the Preparation and Presentation of Financial Statements* that was published in 1989 will be replaced (IASB, 2014:A19). One of the completed phases is the qualitative characteristics. The discussion below explores these characteristics in the context of the headline earnings calculation. There are two fundamental characteristics which are relevance and faithful representation. These fundamental characteristics are discussed in detail in sections 2.5.1 and 2.5.2 below. Relevant information means that the information is significant enough to impact users of the financial statements' decision-making (IASB, 2014:A30). Materiality is covered in the relevance section below. The sections 2.5.3 and 2.5.4 below deal with the enhancing qualitative characteristics which are comparability, verifiability, timeliness and understandability.

2.5.1 Relevance of financial information

Financial statements must be relevant to the decision-making needs of the users, to be useful. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present and future events or confirming, or correcting, their past evaluations (IASB, 2014:A29).

Information can only influence a users' decision-making if it is material considering both the nature and amount (IASB, 2014:A30). Materiality is not prescribed in IFRS and differs from one entity to another. The overriding principle to be applied is that the benefits of providing the information must be greater that the cost (Brearey, 2013:235).

It appears that there is a trade-off between relevance and comparability (Wüstemann & Wüstemann, 2010:21; Whittington, 2008:146). Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items (IASB, 2014:A32). A principles-based accounting standard is likely to provide relevant information, but less comparable information between entities because of the differences in professional judgement (Wüstemann & Wüstemann, 2010:21; Schipper, 2003:61). In contrast, rules-based accounting standards are likely to provide comparable results between entities, but the rules may not be adaptive to changes in circumstances and as a result may not be relevant in all cases.

The disclosure of headline earnings in the financial statements is only important if it provides relevant financial information to a wide variety of users, which can influence the decisions made by the users (SAICA, 2013:5). Information may influence decisions, even if some users choose not to take advantage thereof, or already possess knowledge thereof *via* other sources (IASB, 2014:A29). Information is relevant if it is useful in helping users make better economic decisions than they would have if they did not have such information (Malik, 2011:136). Studies reveal that the EPS is valuable information that users consider in making their economic decisions (Malik, 2011:141; Jordan, *et al,* 2007:343).

Users of financial statements do not view relevance and reliability as independent of each other. Instead, aspects that are associated with reliability influence relevance (Kadous, Koonce & Thayer, 2012:1354). The interdependence between relevance and reliability are not equally mutually exclusive. It was found that factors underlying relevance do not influence judgements on reliability (Kadous, *et al,* 2012:1335). For example, fair value measures are more likely to provide the best approximation of an asset's current value than the cost, particularly when evaluating an asset that was purchased a number of years ago. In this case, fair values provide relevant information, which assist users in deciding the current cost of an asset. On the other hand, if the fair value was determined using a valuation technique which does not take into account inputs both buyers and sellers would consider in making a decision, then questions may be asked about the reliability of the fair value in question (Kadous, *et al,* 2012:1343).

Some studies indicate that during the 2008 global economic crisis, fair value measurement resulted in information that was not relevant in assisting users in the making of economic decisions (Kadous, *et al,* 2012:1337). In particular, Kadous, *et al* (2012) raised questions about whether sales conducted in a distressed market are indicative of an arms' length transaction. This brings into question whether the seller is willing to sell the asset, or is forced to sell the asset due to the economic circumstances. By definition, if the sale was a forced sale, it would not meet the definition of fair value, as this transaction would not constitute an orderly transaction (IASB, 2014:A560). Consequently, the qualitative characteristics of relevance and reliability are equally important in making economic decisions (For a detailed discussion of fair value, refer to section 2.6).

Overall, relevant information can only be provided if the preparers of financial statements are given the option to exercise judgement in applying the requirements of the standards (Wüstemann & Wüstemann, 2010:18). The elimination of rigid rules implicitly assumes that preparers of the financial statements understand their business more than the regulators or those who set the standards.

2.5.2 Faithful representation

Faithful representation means that the economic phenomena represent the transactions and other events it either purports to represent, or could reasonably be expected to represent (IASB, 2014:A30). The information can only be reliable if it is prepared in an unbiased manner in accordance with the chosen framework of preparation. For all JSE listed entities, this means compliance with IFRS and The Circular on headline earnings. Compliance with The Circular assumes that the presented headline earnings is complete, neutral and free from bias. A neutral depiction is presenting the financial results without bias in the selection or presentation of financial information (IASB, 2014:A30).

This means that all significant information is disclosed with both equal prominence and emphasis (IASB, 2014:A30).

Free from error means that there are no errors or omissions in the description and presentation of information as well as in the process used to produce the information (IASB, 2014:A31). Therefore, a faithfully presented headline earnings figure should objectively reflect the true and fair view of an entity's results. If compliance with The Circular results in headline earnings, which does not faithfully represent the performance of an entity, it can be argued that such an entity will not be complying with the IFRS requirements. Similarly, if the headline earnings information provided is not relevant for users' decision-making, such information should not be provided, as it is inconsistent with the objective for providing financial information (IASB, 2014:A23). However, such non-compliance would risk the JSE listing status, unless appropriate disclosures have been made about areas of non-compliance and the impact of compliance in its financial statements (SAICA, 2013:4).

The requirement to disclose the impact of non-compliance is onerous for an entity and is likely to discourage entities from disclosing alternative views. In addition, in a litigation, a non-complying entity is likely to find it difficult to demonstrate that such non-compliance results in faithful representation, particularly when rules are clearly stated (Donelson, *et al,* 2012:1247). The result is that entities tend to present information to comply with the rules rather than to faithfully represent the economic reality of an entity.

The understanding is that if an attempt is made to eliminate the current onerous disclosures for non-complying entities, this may be interpreted as encouraging non-compliance. The consequence of increased non-compliance is not desirable, as it will result in financial statements that are not comparable between different entities. Instead of increased disclosure requirements as a solution to discourage non-compliance with stipulated rules, the alternative may be to include faithful representation as the foundation for headline earnings guidance rather than compliance with rules. In addition, providing the underlying principles which allows preparers to interpret their specific scenarios is likely to increase the users' understanding (Bailey & Sawers, 2012:41).

2.5.3 Comparability

Comparability is not the same as consistency. Comparability is a qualitative characteristic which allows users to identify similarities and differences in financial information (IASB, 2014:A32). Users' decisions involve choosing between alternatives, for example whether to sell or hold shares (IASB, 2014:A32). Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities, also, similar information about the same entity for another period or another date (IASB, 2014:A32).

Consistency refers to the use of the same methods for the same items from one accounting period to another in order to ensure that the financial information is comparable (IASB, 2014:A32). Wüstemann and Wüstemann (2010:1) argued that the consistent application of an accounting standard can only be achieved if specific guidance is provided in the accounting standard. This suggests that the support for rules-based accounting standards will ensure consistent application. However, in cases where the accounting standard or guideline has conflicting rules, for example, in the case of The Circular where guidance includes general rules and industry specific rules, comparing entities across different industries may be a challenge.

Assessment of performance is relative, and it depends on the criteria against which such performance is being evaluated. The conceptual framework argues that, for information to be useful, it must be comparable between the different reporting periods as well as between different entities (IASB, 2014:A32). The purpose of calculating the EPS/HEPS and presenting them in the financial statements, is the comparison of performance of different entities in the same reporting period, and between different reporting periods for the same entity (IASB, 2014:A999; Jordan, *et al,* 2007:343).

One of the EPS/HEPS's limitations, particularly when comparing between different entities, is that accounting policies applied by the respective entities may not be the same, which would result in net profit and consequently the earnings amount being different (IASB, 2014:A999). The study of Cudia &

Manaligod (2011:79) revealed that EPS cannot be used in comparing different entities, because ordinary shares are believed to be a weak indication of an entity’s size.

One of the criticisms of EPS/HEPS is that the number of ordinary shares is assumed to be a fair representation of the entity’s size. However, the EPS/HEPS indicators of performance of an entity may be distorted as a result of the numbers of ordinary shares issued, particularly when EPS/HEPS are the only measures used for evaluating performance (Cudia & Manaligod, 2011:80; Jordan, *et al,* 2007:343).

To illustrate, consider the following example: Entity A and Entity B made headline earnings of R100m within a given year, but Entity A has 200 million shares in issue and Entity B has 100 million shares in issue (all of which were issued for the full year). Entity A would reflect HEPS of fifty cents while Entity B will show HEPS of one rand. According to Cudia and Manaligod (2011:80), this analysis raises the question about whether ordinary shares are a good measure of entity size, thereby also arguing whether EPS/HEPS is a good measure of performance, particularly when comparing the performance of two unrelated entities. Jordan, *et al* (2007:347) found that ordinary shares may be a good measure for entity size for large publicly traded entities, but not for small traded entities. It is concluded that return on assets (RoA) and return on sales (RoS) measures are better inter-entity measures than EPS/HEPS, thereby arguing that total assets and total sales are better measures of entities’ sizes than ordinary shares (Cudia & Manaligod, 2011:80; Jordan, *et al,* 2007:344).

Whether total assets or sales are a better measure of an entity’s size depends on the nature of the industry within which the entity operates (Jordan, *et al,* 2007:345). In a case of investment property entities, it is likely that total assets is an appropriate measure of the entity’s size, which means that return on total assets may be a better reflection of performance than EPS/HEPS. Unlike EPS/HEPS where guidance is available on how the two amounts are calculated (in the form of IAS 33 and The Circular), there is currently no guidance on how to calculate return on total assets. However, it is generally accepted that this ratio is calculated by taking total profit for the period divided by the total assets

(Jordan, *et al,* 2007:345). This ratio takes into account the full profitability of the entity, unlike EPS/HEPS, which only takes into account earnings attributable to the parent entity. The percentage holding of the non-controlling shareholders influences earnings attributable to the parent entity (IASB, 2014:A1001).

Some other studies have argued that the P/E ratio gives a better comparison between different entities than HEPS, as it takes the value that the market is placing on a share relative to the earnings of the entity's, into account (Jordan, *et al,* 2007:344). Using the same example as above, assume that Entity A's shares are trading at sixty rand per share while Entity B's shares are trading at eighty rand per share. The P/E ratio for Entity A and B would be 120 and 80, respectively. This means that the market is more optimistic about the performance of Entity A than the performance of Entity B. This analysis presents different conclusions that would be reached by merely looking at the HEPS or share price separately.

A separate analysis of the HEPS and share price would lead one to conclude that Entity B is better than Entity A. This difference in conclusion can be attributable to the number of shares issued (as a measure of the entity's size) for the two entities, relative to the value of each of the two entities are likely to create for the shareholders. An analysis of the P/E ratio brings the two together and shows that Entity A is likely to create more value for the shareholders than Entity B.

The assumption made in the example above is that both entities are operating in South Africa. Hence, HEPS is presented in the financial statements. However, if either one of the entities is operating outside South Africa, HEPS need not be presented in the financial statements and may not be calculated with ease, given that some re-measurement adjustments may not be easily available in the financial statements. Consequently, it would not be possible to compare the two entities using HEPS as a performance measure.

2.5.4

The verifiability, timeliness and understandability of financial information

The verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of financial information that is relevant and faithfully presented (IASB, 2014:A31). Relevance and faithfully presented are discussed in detail in section 2.5.1 and 2.5.2 respectively. The discussion below is focussed on the verifiability, timeliness and understandability concepts.

The information will be verifiable if an independent party (such as an auditor) will reach the same financial conclusion by using the same data provided (IASB, 2014:A32). The degree of verification depends on a number of factors, which includes whether the information requires judgement in achieving a certain outcome or whether the information represents historical factual information. In most cases, The Circular is prescriptive on what is included and what is excluded, which means that there is less judgement involved in calculating headline earnings number (SAICA, 2013:8). The Circular is not very clear on how to deal with matters which are not specifically dealt with in the circular. For example, in the case where both general rule and industry specific rules are both applicable, which takes precedence.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that in the case where there is no IFRS guidance that deals specifically with a transaction or other event management are expected to use judgement (IASB, 2014:A661). The same principle will be applied in this case which means that management will be expected to use judgment in deciding whether the general rule or industry specific rule should be used.

Information is timely if it is made available to users at the time of a decision and usually represents the latest available information (IASB, 2014:A32). For listed entities, this means that headline earnings needs to be included in the financial statements together with the rest of the financial information. The same information needs to be made available to users in a language that is easy for them to understand (IASB, 2014:A32). The Circular requires specific disclosures to be made with respect to the headline earnings and this includes reconciliation between earnings calculated in terms of IAS 33 and headline earnings (SAICA, 2013:19). The reconciliation helps users of the financial statements understand the adjustments that have been made in calculating headline earnings number.

2.6 HISTORICAL COST VERSUS FAIR VALUE

Re-measurement items as defined in The Circular results in the exclusion of the fair values adjustments in terms of IAS 40 *Investment Property* from headline earnings, but inclusion of fair value adjustments of equity investments in terms of IAS 39 *Financial Instruments: Recognition and Measurement* (SAICA, 2013:17). This exclusion is particularly relevant for investment property entities. The section below aims to discuss the impact of IFRS 13 *Fair Value Measurement* on how fair value was designed, but first discusses the accounting policy options in terms of IAS 40.

In terms of IAS 40, preparers of the financial statements have a choice between recognising the investment property using the historical cost or fair value (IASB, 2014:A1208). Historical cost is deemed more reliable because it is easier to verify, while fair value is deemed more relevant as it provides the most up to date information (Kadous, *et al,* 2012:1336). In terms of the historical cost method, investment properties are initially recognised at cost and subsequently depreciated over the useful life of the property (IASB, 2014:A1207). The depreciation amount is included in the headline earnings calculation (SAICA, 2013:14). The discussion in this study is less relevant for entities applying the historical cost model, but rather applicable to entities using the fair value model.

In terms of the IAS 40 fair value model, there is no depreciation of investment property. Instead, entities are required to fair value the property and include the fair value adjustments in the profit or loss section of the statement of comprehensive income (IASB, 2014:A1209). However, the fair value adjustments are excluded from the headline earnings calculated in terms of The Circular (SAICA, 2013:17). Guidance on the measurement and disclosure of fair value has been removed from IAS 40 and is now included in IFRS 13 *Fair Value Measurement*.

The IASB issued IFRS 13, in May 2011 and it is effective for financial periods beginning on or after 1 January 2013 (IASB, 2014:A578). The main reason for issuing IFRS 13 is to ensure consistent guidance on fair value measurement and disclosures across IFRS standards (IASB, 2014:A538). Before IFRS 13 was issued, different IFRS standards included separate guidance on fair value and there were some inconsistencies on how the concept was defined. In addition, some standards had more disclosure requirements than others did.

In terms of IFRS 13, fair value is defined as the price that would be received to sell an asset or be paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as the exit price) (IASB, 2014:A559). This definition assumes that the market is efficient and all the participants have access to the same information in making their economic decisions. Consequently, the price determined in an inefficient market would not constitute fair value. An example of this would be a distressed sale.

It is important to note the change in the definition from the previous accounting standards, which defined fair value as the amount that could be exchanged between knowledgeable, willing parties in an arm's length transaction (IASB, 2009:2306). The challenge with this definition was that in certain countries transactions do not take place at arm's length. For example, in China transactions are often carried out within social and political networks, rather than at arm's length (He, Wong & Young, 2012:539). Consequently, implementation of the previous definition would not be possible.

IFRS 13 specifically highlights that the fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use (IASB, 2014:A541). What the market participant intends to use the asset for is not taken into consideration in determining the fair value. The following example is a better illustration of the above-mentioned principle: Assume that an entity purchases a property for forty million rand solely for earning rental income. If the highest and best use of the property shows that the property can realise sixty million rand by selling it, fair value would be sixty million rand even though the entity does not intend to sell the property. Highest and best use is determined from the perspective of the market participants, even if the entity intends a different use (IASB, 2014:A541).

In terms of IFRS 13, fair values are classified into three levels namely level one, two and three (IASB, 2014:A551). Level one refers to those traded instruments where fair value is determined by the market. Level two is when fair value is determined by using a valuation technique that takes into account market observable inputs (IASB, 2014:A551). An example of level one includes JSE listed equity shares. An example of level two would be the fair value of unlisted equity shares whose fair value is determined by using the shares of a comparable entity on the JSE as inputs for a valuation model in order to determine the fair value of an unlisted entity.

Level three fair values are based on valuation techniques determined using non-market observable inputs (IASB, 2014:A559). Using the same example as above of an unlisted entity, a level three fair value would be a fair value determined using valuation methodology such as the “Black Scholes” method without taking into account any market observable inputs (IASB, 2014). Typically, this methodology will be used in cases where there is no comparable entity and no market observable inputs that can be used to determine the fair value. Extensive disclosures are required for level three fair values mainly due to the subjectivity of those fair values.

The requirement to measure all items at fair value on initial recognition is likely to result in consistent application, particularly for items that are market observable (Wüstemann & Wüstemann, 2010:13). However, for level three items, which are items calculated using non-market observable inputs such as consistency may not be achieved. In addition, it was found that non-market observable inputs used in determining the fair value creates opportunities for earnings management (He, *et al,* 2012:540). Earnings management is discussed in detail in section 2.7.

The Circular does not deal with the recognition criteria and measurement principles. Rather The Circular uses the concepts as already defined in the IFRS standards and classifies those concepts between adjustments, which are included re-measurement adjustments, and those adjustments that are excluded re-measurements adjustments. Consequently, whether fair value measurement constitutes level one, two or three, does not affect whether such fair value is included in the headline earnings calculation. It is important to understand the classification of each fair value into the three above-mentioned levels as this impacts the volatility of headline earnings.

The introduction of IFRS 13 is likely to affect the determination of fair value particularly in those markets where the previous definition was impractical to facilitate. In the South African context, the impact of IFRS 13 is likely to be in determining what the highest and best use of the assets is. In certain instances, the highest and best use may not be representative of the intention of an entity and it is debatable whether such information provides useful information to the users of financial statements. Fair value determined using the highest and best use means that headline earnings may be overstated in case were an entity does not intend on using the asset for its best use. Using the same example as above, an entity would recognise the fair value of the property at sixty million rand, meaning headline earnings would be overstated by twenty million rand which may never be realised as long as the entity does not intend selling the asset.

2.7 EARNINGS MANAGEMENT

Earnings management can be defined as a manipulation of the financial information in order to achieve a predetermined objective (Johnson, Fleischman, Valentine, & Walker, 2012:910). According to this definition, the intention of earnings management is not to present truthful financial information. Instead earnings management aims to mislead the users of the financial statements.

The quality of EPS or HEPS is dependent on the quality of earnings that is largely dependent on the quality of the profit for the year. Chan, *et al*

(2006:1042) argues that the focus on the bottom line fails to recognise that reported profit is a result of an extended accounting process with considerable room for managerial discretion at every step. There are those that hold the view that principles-based accounting standards are easier to manipulate than rules-based accounting standards (Nelson, 2003:101; Nobes, 2005:32; Schipper, 2003:71).

The manipulation of the profits/headline earnings affects directly on the result of EPS/HEPS. The manipulation of profits is also referred to as earnings management. Earnings management can be categorised into either accounting related or operational related. Accounting related earnings management involves the fraudulent application of accounting policies to suit a specific predetermined objective while operational earnings management involves the timing of the investment/disinvestment (Johnson, *et al,* 2012:910). Operational earnings management is discussed in detail in section 2.7.2.2 while accounting related earnings management is discussed in section 2.8 in conjunction with ethics.

The section below explores earnings management in detail, with a particular focus on whether a rules-based approach or a principles-based approach is more susceptible to earnings management. This section of the chapter is organised as follows: Firstly, the section discusses the distinction between the accrual basis of accounting and earnings management drawing a parallel between IFRS standards (which are largely principles-based) and US GAAP (which are largely rules-based). Secondly, the section discusses an entity's motives for managing earnings by examining if the basis used for standard setting may be a factor in earnings management. Finally, the section discusses whether investment analysts are able to identify earnings management in the financial statements, particularly given the requirement to disclose significant estimates and judgements.

2.7.1 Accrual accounting versus earnings management

In terms of both IFRS and US GAAP, earnings is determined using the accrual basis of accounting, which states that income and expenses are recognised when earned or incurred and not necessarily when cash is received or paid (IASB, 2014:A25). Recognition of income and expenses using another basis than the accrual basis would result in financial statements that are non-compliant with the requirements of IFRS and US GAAP. Although the US GAAP and IFRS accounting standards require the application of the accrual basis in recognising earnings, the application of the concept is different. US GAAP provides detailed application guidance and in certain instances industry specific application guidance are provided. For example, there are over 200 FASB accounting standards on revenue recognition (Sedki, *et al,* 2014:121) compared to the one recently announced accounting standard on revenue in the form of IFRS 15 *Revenue from Contracts with Customers*, which replaced the previous two accounting standards in the form of IAS 18 *Revenue* and IAS 11 *Construction Contracts* (Sedki, *et al,* 2014:122). Hence, US GAAP accounting standards are believed to be rules-based and IFRS principles-based.

The consequence of having so many revenue accounting standards in US GAAP can be looked at in three ways (Sedki, *et al,* 2014:121): Firstly, it means that there is almost a separate revenue accounting standard for each sector of the economy. In each, there are specified rules applicable to that sector of the economy, which differs from the specific rules applicable to another sector. Therefore, it may be very difficult for users of the financial statements to compare the results of one sector of the economy to another economic sector that complicates the users of the financial statements decision-making.

Secondly, it may occur that transactions that are substantially the same in substance may be recognised differently because of the application of different rules applicable to the relevant sectors.

Thirdly, in the case of a multinational conglomerate entity, which operates in a number of different sectors and countries the interpretation of the rules may not always be consistent from one sector to another and one country to another. Similarly, the classification of one sector in one country may not always be consistent with the classification of the same sector in another country.

Given that headline earnings guidance allows sector specific rules, which differ from the general rule in calculating headline earnings this may result in similar consequences as for US GAAP in that the definition of a sector may not be the same in another country compared to South Africa. In the case of the headline earnings calculation, this means that an entity listed on the JSE and operating in different countries needs to ensure the consistent application of the definition of a sector especially if such an entity is impacted by both the general rule and the industry specific rule.

Distinction needs to be made between accrual accounting and earnings management. Earnings management is the purposeful manipulation of figures during the preparation of the financial statements for external reporting (as opposed to presenting the true performance of an entity) (Schipper, 1989:92). Earnings management seeks to portray desired results without necessarily reflecting the true economic performance, financial position and cash flows of an entity (Gowthorpe & Amat, 2005:56). Regardless of whether accounting standards are principles-based or rules-based, earnings management is undesirable because it misrepresents the true economic performance of an entity.

A further distinction needs to be made between intentional and unintentional errors in determining the earnings (Dechow & Dichev, 2002:36). Intentional errors result in earnings management, which is undesirable and is not within the scope of IFRS and US GAAP. Unintentional errors are the consequence of estimation and do not undermine the quality of reporting. Users of financial statements are faced with a challenge of distinguishing between intentional and unintentional errors from reading a set of financial statements prepared using either IFRS or US GAAP (Bailey & Sawers, 2012:26).

It is highly unlikely that users will be able to make such a distinction easily particularly given the limited information provided in a set of financial statements. Some of the reasons why management engages in earnings management are discussed below.

2.7.2

Motives for earnings management

2.7.2.1 Misrepresenting the value of an entity

There are various reasons that incentivise management to engage in earnings management. One of the primary motives of management to manipulate profits is to influence investors' perceptions of the entity's value (Fischer & Stocken, 2004:863). The positive correlation between share price and earnings was found to be an incentive for management to overstate an entity’s value, especially when a P/E ratio is used in the valuation (Menaje & Placido, 2012:41; Seetharaman & Raj, 2011:114). For further discussion on the P/E ratio refer to section 2.4.1.

The higher the entity’s value, the more cash flows the entity will be expected to generate in the future (Chan, *et al,* 2006:1076). However, if the entity’s headline earnings are overstated, the future cash flow will fall short of the market valuation. This means that users of financial statements are likely to make incorrect economic decisions based on the misrepresented headline earnings figure (Stainbank & Harrod, 2007:111).

Studies revealed that the share price includes (amongst other things) analysts’ expectation of quality of earnings that an entity is expected to generate in the future (Barth, Cram & Nelson, 2001:30; Chan, *et al,* 2006:1076). Therefore, the publication of financial results that is lower than the analysts’ expectation results in a lower share price (Barth, *et al,* 2001:30; Chan, *et al,* 2006:1042). As a result, entities are likely to manage their earnings over time in line with the analysts’ expectations. Such evidence suggests that entities who report increasing earnings are likely to see continuous increases in the share price. As a consequence, in order to avoid a decrease in share price (and market capitalisation), management reports earnings which are consistent with the market’s expectations (Dechow & Skinner, 2000:248). This means that in an economic downturn when entities are generally not performing according to expectations, earnings management is likely to increase.

The fall of Enron and Arthur Andersen in the 2008 economic crisis as discussed in section 2.3.3 above illustrates the shortfall of the rules-based approach in emphasising compliance rather than reflecting the true and fair view. In addition, this example further strengthens the perception that rules-based guidance is dysfunctional when there is a change in economic environment (Benston, *et al,* 2006:169)

The former chairperson of the IASB, Sir David Tweedie, was once quoted as saying that a rules-based approach encourages a mentality of "where does it say I can't do this?" It also supports those preparers of financial statements whose intentions are to find a way around the truthful application of the accounting standards, contrary to those who seek to apply the accounting standards in a way that provides useful information (Alles & Datar, 2003:121). This highlights that accounting standards are only effective if the preparers of the financial statements use them in the manner intended by the standard setters (Alles & Datar, 2003:134).

According to Dechow and Skinner (2000:248) in a case where management's incentives are linked to an entity's performance, it was found that an entity, which just 'beat the benchmark', is more likely to be involved in earnings management. Typically, these entities create provisions during boom times to cover downturns. This means that during boom times, not all profits are recorded when earned. Rather some of those profits are deferred and released during downturns in line with investment analysts' expectations (Dechow & Skinner, 2000:248).

In the case described above, management will recognise profits that just meet or slightly exceed analysts' expectations and defer the rest of the profit to the following years (Dechow & Skinner, 2000:248). For example, investment analysts expect that an entity will make R100m, R120m and R150m in the next three years. If the entity makes R150m in year one, management may decide to reflect R110m in year one, and defer forty million rand to the next year particularly if management believes that the next two years may be tough years, and they may not be able to achieve at least R120m and R150m, respectively (Dechow & Skinner, 2000). If in year two, the entity makes ninety million rand, which is lower than the R120m projected by the analysts, management may decide to release thirty million rand of the forty million rand deferred to ensure that the R120m market expectation is met, leaving the ten million rand to utilise in the third year. The result is that in the three years presented, management did not truthfully reflect the performance of the entity in each of the three years. Consequently, the share price is likely to have reacted differently to how it actually reacted when the results were released. Therefore, in each of the three years the entity value determined using the price-earnings ratio is misstated.

2.7.2.2 Management's remuneration

Another motive for earnings management is remuneration (Cheng, Warfield & Ye, 2011:317). Cheng, *et al* (2011) found that management are more inclined to inflate the profit, if doing so will increase their remuneration. Typically, this occurs when remuneration is linked to short-term profit (Cheng, *et al,* 2011:317). In other instances, management is inclined to make short-term decisions, which may negatively affect the future of the business; this is also called operational earnings management (Johnson, *et al*, 2012:910). An example of this includes, when management decides not to spend on certain necessary projects, which may not be profitable in the short term but which are likely to generate higher returns in the long term. When management's performance is measured based on the long-term view, it was found that this reduces short-term decision-making (Cheng, *et al*, 2011:323).

Other studies suggest that management is likely to manage earnings if their incentives are linked to the share price (Cheng, *et al,* 2011:317). The unrealistic earnings expectations of the users of the financial statements are perceived as an incentive for management to overstate earnings (Chan, *et al,* 2006:1042). This is often the case where performance targets are set too high. Using the same example as above, the move from year 1's profit of R100m to R120m represents a twenty per cent increase. In a given year, management may deem it easier to achieve R100m in year 1 and to achieve ten per cent in year two rather than the twenty per cent anticipated by the market. In order to avoid releasing disappointing results, management manipulates the profits to meet the analysts' forecasts (Dechow & Skinner, 2000:248).

The above example illustrates that as long as accounting standards allow significant estimates to be made in the preparation of the financial statements management may use this latitude to reflect predetermined earnings. Alles and Datar (2003:121) argue that accounting standards need to have built in internal controls that allow audit committees and the external auditor to monitor the truthful implementation of the accounting standards by management. In the case of rules-based guidance, detailed implementation guidance is believed to be one way of building internal controls into the accounting standards (Alles & Datar, 2003:121).

2.7.2.3 Government regulation

In other cases, government regulations create an incentive for preparers of financial statements to manipulate earnings. For example, in China if an entity posts losses for three years' running, such an entity will be delisted (He, *et al,* 2012:539). In this case, in order to avoid being delisted, an entity may create a special purpose vehicle to facilitate fictitious sales, which will ensure that the entity does not make losses in the three years. This may be compared to the Enron situation described in section 2.3.3 above.

The move of China from rules-based accounting standards to principles-based guidance in the form of IFRS was seen by many as a step in the right direction in reducing earnings management (He, *et al,* 2012:539). Similarly, Bouchareb, Ajina and Souid (2014:278) found that the adoption of principles-based accounting standards with a strong governance mechanism can deter earnings management. This means that regardless of management's incentive to misrepresent earnings, if there are strong governance mechanisms and well defined accounting principles; management's ability to manipulate earnings may be limited. Some of these governance mechanisms include strong corporate governance principles (Bouchareb, *et al,* 2014:278).

Strong corporate governance principles include (amongst others) (Bouchareb, *et al,* 2014:278): firstly, the correct balance between independent non-executive directors and executive directors on the Board of directors (the Board); secondly, ensuring that the composition of the Board of directors consists of majority independent non-executive directors; thirdly, the separation of the chief executive officer's role from that of the chairperson of the board, with the chairperson being an independent non-executive director; and lastly, a strong audit committee and independent external auditors.

Independent non-executive director refers to those directors who are not involved with the day-to-day running of the entity (Bouchareb, *et al,* 2014:267). In addition, Bouchareb, *et al* (2014:278) found that the higher the percentage of independent non-executive directors, the weaker the earnings management.

The above analysis highlights that principles-based accounting standards are not the only solution to eliminating earnings manipulation. Instead, the solution is the combination between well-articulated accounting principles and enforcing those principles through the adoption of corporate governance.

2.7.3 Identifying earnings management

Management may make certain significant judgements and estimates in determining headline earnings for the year, which are subjective such as estimating the useful life of property, plant and equipment (Chan, *et al,* 2006:1042). In terms of IFRS, these significant estimates and judgements are required to be disclosed in the financial statements in order to assist users in making informed decisions about the performance and position of an entity (IASB, 2014:A616). A study by Dechow and Skinner (2000:247) found that disclosure of estimates and judgments may help users identify earnings manipulations. These disclosures also help users assess the impact on the headline earnings calculation should any of these estimates change or if a different variable other than the one used by management was to be factored. For example, management may have used the income method in calculating the fair value of an investment property and may have assumed a certain rental escalation rate over the years and a specified discount rate taking into account the risk factors associated with such a property. The income method refers to a valuation that considers future earnings to be generated from an asset in making the valuation (Kusano, 2012:141). Any change either to the rental escalation rate or to the discount rate would have a direct impact on the value of the property. Consequently, it is critical for users to know what estimates and judgements have been applied in determining the value of the property.

Similarly, it is important to know that management decided to use the income method as other users may disagree with this approach. For example, using the income approach may be inappropriate if the property under question consists only of land that cannot be leased separately from a building. Perhaps using the sale approach may be the more appropriate method. The sale approach refers to a valuation which is based on the amount to be realised when the asset is sold (IASB, 2014:A559; Kusano, 2012:141). The definition of fair value in IFRS 13 is based on the sale approach because it assumes that the value of the assets or liabilities will only be realised through sale (IAS, 2014:A559).

The required disclosures of significant estimates and judgements is better achieved if no specification is made of what needs to be disclosed and preparers of financial statements are required to use their judgements (IASB, 2014:A661).

Specifying which disclosure is required is likely to result in a check box exercise, whereby management would ensure that all prescribed disclosures are made while omitting those disclosures that are not listed (IASB, 2014:A661; McEnroe & Sullivan, 2012:33). Checklist type standards are more likely to be rules-based accounting standards, such as the accounting standards of US GAAP.

A check box practice encourages compliance with the prescribed accounting standards rather than reflecting decision useful information in the financial statements (McEnroe & Sullivan, 2012:33). For example, omitted disclosures may include critical information that has the potential of influencing users' economic decision-making.

Disclosure of estimates and judgements helps the user of financial statements to understand and evaluate the inherent risk in reading a set of financial statements (IASB, 2014; Wüstemann & Wüstemann, 2010:1; Schipper, 2003:61). In fact, IAS 8 *Accounting Policies, Changes in Accounting Estimates* *and Errors*, states that the use of estimates and judgements makes it possible for management to present relevant information that does not undermine the reliability of the financial statements (IASB, 2014:A666). For example, management makes an estimate regarding the useful life of property, plant and equipment and uses that estimate to depreciate these assets. Similarly, management makes an estimate regarding the net realisable value of inventory. Depreciation and net realisable estimates affect the calculation of headline earnings. Therefore, understanding what estimates and judgements were involved in the preparation of the financial statements impacts on the understanding of headline earnings. Misstatement of the headline earnings amount affects the calculation of the P/E ratio. The P/E ratio is used to estimates returns that an entity is likely to generate in the future, which means that a misstated P/E ratio results in the value of an entity being misrepresented.

The subjectivity in judgement, however, also means that some decisions cannot be described as being either correct or incorrect, but may only be accepted as an appropriate application of the requirement (Wüstemann & Wüstemann, 2010:1; Schipper, 2003:61). Using the same example as above, deciding on the method of valuation and related inputs (such as which discount rate to use) in valuing the property is subjective, particularly given that in some instances those inputs are not market observable and are likely to be classified as level two or three as defined in section 2.6 above. For example, one professional may decide to allocate two per cent to risks associated with the property and another professional may decide to allocate two-and-a-half per cent. Whether two per cent or two-and-a-half per cent is added to the discount rate impacts on the valuation and as such the profitability of an entity.

Other studies, such as Alles and Datar (2003:134) found that besides the requirements to disclose estimates and judgements, investors are incapable of perfectly filtering the manager's reporting bias and therefore earnings manipulation reduces the usefulness of earnings and efficiency of share prices. This is particularly the case where management are concealing the application of accounting policies in order to achieve predetermined results. In such a case, it is unlikely that management will disclose the inappropriate application of the accounting policy in a set of financial statements. Therefore, users of financial statements may not be privileged to know or identify such a practice. Such a practice raises questions about the ethics of management in the preparation of the financial statements. Ethics is discussed in detail in the next section.

2.8 ETHICS

The discussion on earnings management and its consequential impact on the calculation of headline earnings and the price-earnings ratio may not be complete without the assessment of whether such actions are considered to be ethical. The purpose of this section is to discuss instances in which earnings management may be considered ethical and those instances in which such actions are considered unethical.

The rest of this section is organised as follows: Firstly, the ethics of earnings management will be discussed with particular focus on whether some implementation rules contained in the accounting standards may have been influenced by broken trust between standard setters, preparers and users of financial statements (Bailey & Sawers, 2012:41; Aßländer, 2005:63). Secondly, the section discusses ethics in the context of corporate failures evaluating the effectiveness of rules-based accounting standards in enforcing ethical behaviours. Finally, this section discusses whether the application of principles-based accounting standards or rules-based accounting standards would be more effective in enforcing ethics.

2.8.1 The ethics of earnings management

Earnings management is not breaking the law, but it is the breach of moral obligations (Gherai & Balaciu, 2011:35). Moral obligations require questions to be asked about the ethical behaviours of the preparers of financial statements. Johnson, *et al,* (2012:910)'s study found that earnings management undertaken to enhance personal gain (such as increasing an individual's bonus) is unethical. However, there are differing views amongst scholars of whether earnings management, which has positive results for the organisation, would be unethical. Elias (2002:42) found that such a practice would be acceptable while other studies such as Kaplan, McElroy, Ravenscroft & Shrader (2007:160) found that such a practice would not be acceptable. In Kaplan, *et al* (2007:160), it is argued that management's intention should not be taken into account when deciding whether an action is ethical or not. The consequence of such an action results in misleading stakeholders about the true value of an entity (Kaplan, *et al,* 2007:161). As a result, such an action is deemed unethical.

Some studies such as Bailey and Sawers (2012:42) and Psaros & Trotman (2004:91) found that detailed rules contained in the accounting standards such as US GAAP are included in the standards because the standard setters do not trust the preparers to act in an ethical manner. Therefore, it is believed that allowing preparers of financial statements to use their judgements is unlikely to achieve unbiased financial results.

If preparers of financial statements are ethical, it is unlikely that there will be a need to include anti-avoidance provisions or the so called 'bright line test' in the accounting standards (Bailey & Sawers, 2012:27-28; Psaros & Trotman, 2004:77). Similarly, some corporate failures may have been avoided if the preparers of the financial statements were truthful about the state of financial affairs of an entity.

2.8.2 Ethics in the context of corporate failures

Corporate failures such as Enron (used to be one of the largest energy providers worldwide, based in the United States of America) highlight the need for professionals to act ethically with the view to complying with the intention of accounting standards rather than misleading the users of the financial statements. In the case of Enron, the entity managed to issue unqualified financial statements that claimed compliance with accounting standards, but the liabilities of the entity were understated by using, amongst other things, special purpose vehicles, amongst others (Gherai & Balaciu, 2011:34). Special purpose vehicles are those entities that are created to achieve a predetermined objective and have limited activities (Aßländer, 2005:64).

Unfortunately, non-compliance with ethics is usually highlighted when there are big incidences such as corporate failures or an economic downturn (Johnson, *et al,* 2012:913). The usual reaction is to increase regulation. An example thereof is the introduction of the Sarbanes-Oxley Act in the USA because of the corporate failures and accounting scandals such as Enron and their auditors Arthur Andersen in an effort to renew investors' confidence. Arthur Andersen expressed an unqualified audit opinion on Enron's annual financial statements even though Enron had failed to disclose some of its liabilities in the financial statements. This raised questions about the independence of the auditors (Aßländer, 2005:64).

The reaction to increase regulation fails to address the underlying causes of such failures. The same can be said about the inclusion of increased guidance in a principles-based accounting standard with a view to ensure the consistent application thereof. Consistent application can only be achieved if the preparers of financial statements are unbiased and ethical. Therefore, the debate about which accounting standards are superior between rules-based accounting standards and principles-based accounting standards would be irrelevant.

2.8.3 Ethics enforcement

Rose (2007:321) argued that ethical decisions require compliance with the law and cooperation with the underlying spirit of the law. It is important to emphasise that compliance with rules-based accounting standards alone is not a guarantee that the financial statements will fairly reflect the performance and position of an entity (Balaciu, Bogdan, Mester & Gherai, 2012:216). There may be information that is not specifically requested by the accounting standards, but which may be relevant for decision-making purposes. Therefore, in the spirit of being transparent to the users of financial statements it would be appropriate to disclose such information (Rose, 2007). Similarly, the use of professional judgement by preparers of financial statements needs to reflect an unbiased financial performance of an entity.

A study done by Rose (2007:319) found that directors sometimes make decisions that emphasise legal defensibility at the expense of personal ethics and social responsibility. In a rules-based accounting standard, compliance is likely to be based on what can be proved in a court of law rather than providing a true and fair reflection of an entity's financial performance and position (Rose, 2007:319). In contrast, in principles-based accounting standards, compliance is subject to judgement and is likely to encourage faithful representation rather than compliance.

Preparers of financial statements have a fiduciary duty to provide faithful representation of financial information that will be in the best interest of all the stakeholders of an entity (IASB, 2014:A30). In executing such a duty the preparers of financial statements do not need detail regarding the regulation and anti-avoidance provisions in order to monitor compliance nor do they need regulators to remind them of their responsibility (Rose, 2007:329). Instead, preparers of financial statements need to act in an ethical manner regardless of the provisions of the accounting standards. In cases where auditors believe that the preparers of financial statements have failed to comply with the ethical requirements, the auditors have a duty to report on such non-compliance. The role of the auditors is discussed in detail in the next section.

2.9 ROLE OF THE AUDITORS

In terms of the JSE listing requirements, auditors are required to qualify their audit report if an entity is not complying with The Circular's requirements (SAICA, 2013:7). This means that auditors play a critical role in complying with the financial reporting requirements of a JSE listed entity. Rules-based accounting standards are believed to be easier to audit than principles-based accounting standards because compliance with rules is easier to verify than professional judgement, which is a matter of opinion (Jamal & Tan, 2010:1326; Illiano, 2012:26). Verifiability helps assure users that the information faithfully represents the economic phenomena it purports to represent (IASB, 2014:A32). For example, an unqualified audit opinion provides users of financial information with evidence that the financial information is verifiable.

The significance of the auditors' role in financial reporting means that the debate about the preference for a rules-based approach or a principles-based approach should consider the impact on the audit opinion (Jamal & Tan, 2010:1329). This also suggests that auditors should play a role in determining whether accounting standards should be rules-based or principles-based. Jamal and Tan (2010:1325) found that a move towards more principles-based accounting standards is likely to result in improved quality of financial reporting only when there is a corresponding shift in the auditors' mind-sets toward being more principles-oriented.

Jamal and Tan (2010:1326) argued that auditors can be classified as rules-oriented, principles-oriented, or client-oriented. Rules-oriented auditors are considered to be those auditors with a greater concern for adhering to the well-specified rules rather than to the capturing of the underlying substance of the transaction while principles-oriented auditors are more concerned with the underlying economic substance of the transaction (Jamal & Tan 2010:1326). Client-oriented auditors are concerned about pleasing the client rather than reporting the economic reality (Jamal & Tan 2010:1326). These auditors look for loopholes in an accounting standard that favours the client without consideration for the economic reality of the transaction. Enforcing principles-based accounting standards in order to achieve the intended objective requires both the auditors and the client to have a common goal, which is to provide an unbiased, true and fair representation of the financial performance of an entity.

Given the rules-based approach of The Circular, it seems as if there is emphasis on compliance rather than providing useful information. Complying with the guidance provided in the headline earnings accounting standard seems to be a 'tick box' exercise and shifts focus away from the provision of relevant information that will help users in making economic decisions. This approach makes it easier for rules-oriented auditors to perform audits and provide an opinion on whether the financial statements provide a fair and true reflection of the entity's operations. In contrast, principles-oriented auditors would struggle with some of the rules imposed by The Circular, particularly when compliance with these rules would not reflect the economic reality of the financial results. However, it would be difficult for principles-based auditors to convince their clients why non-compliance with these stated rules results in a better reflection of the performance of an entity when the guidance provides a rule without expressing the objective of what that rule aims to achieve.

For example, in the case of The Circular it is not clear why a life insurance entity should include fair value measurements in determining their headline earnings and an investment property entity, whose ordinary activities involve the renting or holding of property for capital appreciation, excludes the fair value re-measurements relating to their properties. The rule is very clear in the headline earnings guidance, but there is no guidance on why it is acceptable for a life insurance entity to include investment fair value re-measurements in the calculation of headline earnings but that this practice is not acceptable for an investment property entity.

Jamal and Tan (2010:1344) found that it is critical that the auditors and clients work together in enforcing principles-based accounting standards to achieve the intended objective of financial reporting, which is to faithfully present the financial position and performance of an entity.

Prior research has found that the auditors have an incentive to please their client given their dependence on the client fee (Jamal & Tan 2010:1330; Li, 2009:203). Blay and Geiger (2012:3) found that an auditors' independence is likely to be impaired in cases where the auditor would like to retain the client with a view to generate future fees.

Li (2009:201) argued that the large non-audit fees could cause auditors to become financially dependent on their clients. Lim & Tan (2010:923) found that extended auditors' tenure could create economic incentives for auditors to lose their independence. The result is that auditors may be inclined to support the incorrect application of accounting principles by their clients.

Balaciu, *et al,* (2012:214) argued that auditors in performing their duties have mixed feelings between pleasing the client who employed them and protecting the interests of the users of the financial statements. It is argued that ethics and compliance with the laws prevent the auditing profession from being commercialised due to the requirements for auditors to be independent from their clients and to protect the interest of the users of financial statements (Balaciu, *et al,* 201:236). Strong corporate governance within an entity may help to alleviate this issue particularly if the board of directors makes the appointment of the auditors and the board consists of a majority of independent non-executive directors. For further detail on the corporate governance discussion, refer to section 2.7.2.3 above.

An unqualified audit opinion gives users assurance that the financial information faithfully represents the financial results (IASB, 2014:A32). Donelson, *et al,* (2012:1247) found that although rules-based accounting standards are associated with a lower incidence of litigation against the auditors, no evidence has been found to support that such an approach influences the litigation outcome. The implication of this finding is that verifiability may not be used as an argument to support a rules-based approach.

Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, for example auditors and preparers of the financial statements on whether an event or transaction is faithfully presented in the context of the financial performance and position of an entity (IASB 2014:A32). Therefore, it can be argued that different interpretations of the rules or principles will not alter the usefulness and reliability of financial information, should two independent professionals not be in complete agreement with each other.

An audit report enhances the credibility of financial statements. As stated above, an unqualified audit report implies that the financial statements faithfully reflect the financial results it purports to reflect. An implicit assumption is that the auditors have acted independently and were not influenced by the fees received or to be received.

Principles-based accounting standards are likely to increase discussions between the auditors and their clients about the appropriate accounting treatment. This will be a result of the subjectivity of the use of judgement in the preparation of financial statement that is useful to a wide variety of users. Decision usefulness theory is discussed in detail in the section below.

2.10 DECISION USEFULNESS THEORY

IFRS standards and US GAAP are based on the concept of decision-usefulness theory, which forms the basis of the Conceptual Framework and indeed the accounting standards. Decision usefulness theory says that information is prepared to satisfy the needs of the primary users of the financial statements (Dandago & Hassan, 2013:773). In the case of headline earnings, the primary users would include investment analysts, fund managers, investment analysts, lenders and other creditors (SAICA, 2013:5; IASB, 2014:A23). Investment analysts and fund managers will require the financial information in making a decision on which entity to invest in or recommend to their clients while lenders and creditors will require financial information to assess if the entity will be able to repay its debts.

A set of financial statements comprises a statement of profit or loss and other comprehensive income, a statement of changes in equity, a statement of financial position, a statement of cash flows and notes to the financial statements including notes on accounting policy (IASB, 2014:A592). Each of these statements is equally important in users' decision-making. The calculation of headline earnings is based on profit or loss as per the statement of comprehensive income.

Decision usefulness theory requires each entity to identify their primary users of the financial statements and their respective needs. The entity then needs to provide reliable, valuable and relevant information that their respective users require, which is capable of influencing users decision-making (Brearey, 2013:229).

Disclosure of headline earning in the financial statements provides users with an indication of an entity's performance after excluding non-recurring items (Venter, *et al,* 2013:26). Venter, *et al* (2013:48) found that requiring entities to disclose headline earnings results in the correct valuation of a consistent P/E ratio. Financial statements represent the communication between an entity and its various user groups about the entity's performance and position of such an entity. Venter, *et al* (2013:26) argued that in a case where the disclosure of headline earnings is not mandatory, it is not possible for the share price to reflect the correct valuation of the P/E ratio. In South Africa disclosure of headline earnings is mandatory, which provides users of JSE listed entities with additional information that other users of financial statements in other stock exchanges do not have.

The application of decision usefulness theory means that users of financial statements are provided with the information that will address their specific needs (Dandago & Hassan, 2013:774). The disclosure of headline earnings is not an IFRS requirement, but it is a JSE listing requirement (SAICA, 2013:3). SAICA's 2006 survey included a wide variety of users such as fund managers and analysts, to name but a few and the outcome indicated that there is a need for headline earnings in South Africa (SAICA, 2013:5). This is an example of decision useful information, which is specific in the South African context. The IASB makes provision for entities to disclose information which would enhance the users' understanding of financial information, even if it is not specifically required in any of the IFRS accounting standards (IASB, 2014:A662; SAICA, 2013:3). The JSE tasked SAICA with the mandate to draft the original guidance and to update The Circular as and when the IFRS accounting standards changed (SAICA, 2013:4).

2.11 SUMMARY AND CONCLUSION

Headline earnings guidance has evolved since the issue of AC 306 in 1995, which was the first guidance issued on headline earnings in South Africa. From the beginning, the headline earnings guidance was a rules-based guidance. The rules have been criticised as being arbitrary and mechanical, encouraging reliance on a number rather than the assessment of the overall performance of an entity based on the information in the financial statements. Although it is not the intention of the headline earnings figure to represent maintainable earnings, users of financial statements perceive headline earnings to represent maintainable earnings, which it is not.

The continuous changes in the headline earnings requirements reflects the very notion that accounting is a social science and that it is influenced by changes in political, religious and economic aspects. Questions about the appropriateness of the rules-based guidance need to be asked particularly given that SAICA is one of the supporters of the principles-based approach in setting accounting standards. It would be expected that The Circular set by SAICA would reflect this objective. In addition, given the inflexibility of a rules-based approach to adapt to a constantly changing environment, a principles-based approach appears more appropriate. However, a principles-based approach relies on the use of professional judgement, which means that the preparers need to act in the best interest of all the stakeholders.

The question of whether principles-based accounting standards are superior to rules-based accounting standards requires assessment of the impact each accounting standard has on the faithful representation of information and whether the information provided will be useful to a wide range of users in making their economic decisions. Information is useful if it is relevant to users' decision-making and if users are able to compare such information between one entity and another and from one year to another.

There are a number of ways to determine the value of an entity, which encompasses both financial and non-financial performance measures. One of the financial measures is the use of the price-earnings ratio. In the South African context, earnings used in the calculation of the price-earnings ratio can be determined by using either IAS 33 or The Circular on headline earnings. The question of whether HEPS is relevant in the global context, particularly given that South Africa is the only country where HEPS is a listing requirement, still needs to be debated (SAICA, 2013:4). The requirement to have a circular on HEPS may be perceived to be contrary to the IASB's objective to harmonise global standards. The P/E ratio helps to compare the results of one entity to another in the same industry or in different industries. Similarly, the same comparison can be made for one entity in one country to another entity in another country. The use of the P/E ratio when comparing a South African entity to an international entity requires caution in ensuring that the earnings number is consistently defined.

Re-measurement items as defined in The Circular results in the inclusion of some fair value gains or losses in the calculation of headline earnings and the exclusion of others. For example, fair value gains or losses relating to financial instruments within the scope of IAS 39 and IFRS 9 are included in the calculation of headline earnings. However, fair value gains or losses relating to investment properties within the scope of IAS 40 are excluded from the headline earnings calculation. The reason for this inconsistent treatment is not very clear.

The introduction of IFRS 13 *Fair Value Measurement* is likely to result in the consistent application of fair value measurements within IFRS. Although this clarification will not address the inconsistent headline earnings treatment raised above, it will address how the fair value of both financial instruments and non-financial instruments are measured. However, the use of non-market inputs in determining level three fair values is likely to create incentives for earnings management. It remains debatable whether earnings management is ethical, particularly in cases where it has a positive impact on the entity. However, there seems to be a consistent standpoint amongst scholars that earnings management for personal gain is unethical.

Auditors play a pivotal role in ensuring that entities comply with IFRS and indeed the requirements of The Circular on headline earnings. The significance of the role played by the auditors in enforcing compliance, means that the decision on whether the headline earnings guidance should be rules-based or principles-based, should consider the impact on an audit opinion. Although rules-based accounting standards make it easy to provide evidence of compliance, the financial statements may not always reflect economic reality, which will result in compliance in form and not substance. Therefore, in certain instances the auditors may be able to challenge the true and fair representation of results especially if the client has complied with the JSE listing requirements. Fair representation requires that both the auditors and their clients have a common goal, which is to provide unbiased results. This means that the entity's earnings need to reflect the income earned and expenses incurred during the period, and not necessarily, the cash received or paid.

2.11.1 Summary of Chapter 2

Table 2.1 A visual summary of Chapter 2:

<table>
<tr><th colspan="2">Introduction</th></tr>
<tr><td>History of headline earnings:
• Guidance was first issued in 1995;
• No international guidance at that stage;
• IAS 33 was only issued in 1997 and adopted in SA in 2004;
• A reason for early issue was to reduce volatility;
• Objections raised at first issue included:
– that some of the rules are arbitrary;
– The calculation of HEPS promotes reliance on a one-figure EPS for decision-making; and
– Headline earnings may be mistaken for maintainable earnings which it is not.</td><td>Rules versus principles debate:
• Rules-based accounting standards have detailed guidance (e.g. US GAAP);
• Principle-based accounting standards are high level guidance (e.g. IFRS) and rules-based accounting standards contain detailed guidance (e.g. US GAAP);
• Accounting is a social science;
• Principles-based accounting standards rely on judgements;
• Rules guidance tries to cover all possible cases;
• Rules guidance is not adaptive to changes; and
• Corporate failures highlight compliance in form rather than substance.</td></tr>
<tr><td>Equity valuation:
• Headline earnings is useful in determining entity's valuation particularly if a P/E ratio is used;
• Equity valuation is not limited to financial measures which are governed by IFRS, but also includes non-financial measures, which are outside the scope of IFRS;
• Non-financial measures include entity contributions to society and productivity;
• Financial measures include HEPS,</td><td>Qualitative characteristics:
• Relevant information helps users make better economic decisions;
• Faithful representation reflects unbiased, true and fair view of results;
• Information is useful if it is comparable and consistently applied; and
• In comparing financial results of different entities, there is a need to factor in entities sizes.</td></tr>
</table>

EPS and P/E ratios; • There is high correlation between earnings and share price (Menaje & Placido, 2012:36; Jordan, *et al,* 2007:343); and • Calculation of headline earnings impacts upon entity valuation.	
Historical cost versus fair value: • The study is relevant for entities using the fair value option in IAS 40 and not historical cost; • Streamline fair value concept in terms of IFRS 13; • The introduction of IFRS 13 did not change the re-measurement concept; • Fair value is classified into levels one to three; • Level three measurement may result in volatility in headline earnings; and • Highest and best use concept may result in misstatement of headline earnings.	**Earnings management:** • Headline earnings quality is dependent on the quality of profit; • Earnings may be subject to manipulation by management; • Earnings management comprises the fraudulent application of accounting policies and operational earnings management; • There is a distinction between the accrual basis of accounting and earnings management. The accrual basis refers to the recognition of income and expenses in the period that they relate to while earnings management refers to the misrepresentation of financial information; • Both IFRS (principles-based standards) and US GAAP (rules-based standards) require the use of the accrual basis; • Motives for earnings management include misrepresentation of entity value, management's remuneration and government regulation; and • Disclosure of estimates and judgement may help identify earnings management.

Ethics:	Role of the auditors:
• Earnings management may be ethical if it has positive results for the organisation; • Earnings management for personal gain is unethical; • Corporate failures could be avoided if management is ethical; • Lack of ethics results in compliance in form and not in spirit; and • Strong corporate governance and clearly defined rules may enforce the correct application of accounting standards.	• The auditors' role is to express an opinion; • The debate about the appropriateness of rules-based guidance or principles-based guidance needs to consider the impact on audit opinion; Overriding principle should be a true and fair view of financial results; and • Verifiability means that different professionals could reach consensus even if not in complete agreement.
Summary and conclusion	

Chapter 3 discusses the research design followed in determining the appropriateness of headline earnings guidance.

Chapter 3: Research Design

3.1 INTRODUCTION

The research design chapter describes how the author went about solving the problem statement of the study (Hofstee, 2009:108). Before describing the research design of this study, it is helpful to provide an overview of the study.

Chapter 1 introduces this study and describes the problem statement. Chapter 2 discusses the theoretical literature on the research problem by focussing on the importance of headline earnings and why it is deemed necessary to have rules-based guidance rather than a principles-based accounting standard. The debate about rules-based guidance versus principles-based guidance is expanded to include the USA situation that adopted a rules-based approach to standard setting by focussing on what this may mean for South African listed entities.

Such an observation is particularly relevant when considering that the SAICA Circular 2/2013 (The Circular) requires that all fair value measurements relating to investment property are excluded from the headline earnings calculation, but provides for special rules relating to life insurance entities to include such fair value measurements in their calculation of headline earnings. The ordinary activities of investment property entities involve renting those properties or carrying the properties for capital appreciation. What remains unclear is whether an entity in a conglomerate can apply more than one rule in its consolidated financial statements if such an entity operates in more than one industrial sector. In addition, there are industry specific rules for life insurance entities and no industry specific rules for property industry entities. The dissimilarity is that Life insurance entities made representations to the JSE, stating that the general requirement as applicable to the property industry entities does not provide useful information to their users, and that the property industry entities did not make the same representation.

Chapter 2 emphasises that South Africa is the only country that requires that all listed entities disclose headline earnings in their annual financial statements.

The implication of this requirement is that the price-earnings ratio of a South African listed entity can be calculated by either using the earnings calculated in terms of IAS 33 *Earnings Per Share* or in terms of SAICA's Circular on Headline Earnings. Consequently, when comparing an international entity's price-earnings ratio to a South African entity's price-earnings ratio it is important to establish which earnings number was used to calculate the South African entity's price-earnings ratio. If a South African entity uses a headline earnings number, the P/E ratio may not be comparable to the P/E ratio of an international entity.

This raises the question of the relevance of the JSE listing requirement for South African listed entities to disclose headline earnings, whereas their international counterparts are not subject to such a requirement. It is questionable whether such requirements enhance the international investor's understanding of the South African entity, or are the investors exposed to information overload, that is not necessary for decision-making.

The purpose of this chapter is to explain the research design used in determining whether a rules-based approach or a principles-based approach is more appropriate for the calculation of headline earnings of listed property entities on the JSE Limited, for economic decision-making purpose. This study follows a survey-based approach.

3.2 RESEARCH METHODS

3.2.1 Survey-based approach

McEnroe and Sullivan (2012) used a survey-based design in assessing the auditors' perceptions regarding which type of accounting standard is better: rules-based accounting standards or principles-based accounting standards. The focus of the McEnroe and Sullivan (2012) study was to determine the more appropriate approach to standard setting between a rules-based and principles-based. This study aims to answer a similar question in the context of headline earnings. As a result, this study follows a similar methodology as McEnroe and Sullivan (2012). Survey-based research design, is essentially trying to elicit information from a limited number of individuals who are presumed to have the information one is seeking, who are able and willing to communicate, and who are (nearly always) intended to be representative of a larger group (Hofstee, 2009:122). The views of the Chief Financial Officers (CFOs) of the investment property entities and investment analysts are likely to be representative of the views of the preparers and users of financial statements.

A survey-based approach was adopted by SAICA in determining the significance of headline earnings guidance in order to decide whether there is a need for the guidance (SAICA, 2013:4). Similarly, Stainbank and Harrod (2007:96) conducted a survey study in establishing preparers' (represented by financial managers) perception about HEPS, in particular its importance of performance measurement. Amongst other things, the Stainbank and Harrod (2007:97) study considered whether preparers believe HEPS is a measure of maintainable earnings, whether preparers agreed with the adjustments required in calculating headline earnings and whether they believe HEPS is easy to manipulate.

Based on the above discussion, survey-based empirical research is considered the most appropriate methodology for this study. This study will adopt a similar approach as in McEnroe and Sullivan (2012), which means that this study will use a quantitative empirical approach in reaching a conclusion. The strategy employed in a quantitative approach is that of enquiry such as an experiment or survey and requires the collection of data using a predetermined instrument that yields statistical data (Creswell, 2015:18). The predetermined instrument in this study is a questionnaire and is discussed in detail in the following section.

3.2.2 Questionnaire

A questionnaire is defined as a form of structured interviewing, where all respondents are asked the same questions and often are offered the same options in answering them (yes/no, ranked on a scale, etc.) (Hofstee, 2009:132). In order to obtain the necessary information to answer the research question a questionnaire was distributed to the CFOs of listed real estate investment and services entities and investment analysts. The questionnaire was distributed to the participants using e-mail and the participants were asked to click on the following website link to complete the questionnaire: http://survey.surveybasket.co.za/8293319453784/

The opening page of the link provided background information about the study and outlined the purpose of the study. Participants were requested to consent to their participation in the study. If they clicked on no, then the web page would be closed. If they clicked on yes, then they would be able to access the rest of the questions in the questionnaire. The questionnaire was first distributed on 10 March 2014 and was closed on 25 July 2014. There were a number of follow up e-mails between the first date of distribution and the last day when the survey was closed.

A questionnaire was prepared offering participants five options according to the Likert scale method, namely: Strongly disagree, disagree, neutral, agree and strongly agree to each of the statements provided. All participants were offered the same questions. The questionnaire is included in the appendix to this study. Besides asking the participants for their occupation and age group, the questionnaire contained ten main questions. The questions can be grouped into four main sections, which are fundamental characteristics (five questions), enhancing characteristics (three questions), role of the auditors (one question) and costs versus benefits (one question).

Mr Hennie Gerber assisted in capturing and analysing the data once all the participants had completed the survey on the internet. The system used to analyse the results is SAS JMP version 10.

The IASB considers the Conceptual Framework to be the basic reference guidance for all accounting standard setting principles (IASB, 2014:A21). In order to assess whether headline earnings guidance should be rules-based or principles-based it is appropriate to base the assessment on the basic principles of accounting guidance for providing decision-useful information to the users of the financial statements. These principles are outlined in the Conceptual Framework as the fundamental characteristics, enhancing characteristics, the use of professional judgment and costs versus benefits. As a result, the questions used in the survey were based on these principles.

The questionnaire was divided into four main sections based on the requirements of the revised Conceptual Framework. These sections are the fundamental characteristics, enhancing characteristics, role of the auditors (use of professional judgement) and the costs versus benefit of useful financial information.

3.3 LIMITATIONS

One of the limitations of this study is that the researcher was not able to observe or interact with the participants and was not able to probe the participants for more clarity. However, the result of this study is likely to raise the level of debate on the subject and is likely to provide the basis for future studies.

3.4 POPULATION

This study aims to evaluate a preferred approach in calculating headline earnings of listed real estate investment and services entities between a rules-based headline earnings guidance and a principles-based headline earnings guidance particularly given that the fair value adjustments of an investment property are excluded from headline earnings. According to Hofstee (2009:122) the target population should comprise everyone of interest who could possibly be included in a research study and to which the research findings may reasonably be generalised.

The population used for the study includes the CFOs of real estate investment and services entities. In addition, the study also includes the investment analyst group as detailed below:

Table 3.1 Population

Population	**Number**
Listed real estate investment and services entities	26
Investment analyst	61
Total	**87**

CFOs and investment analyst communities are expected to have sufficient knowledge of the headline earnings guidance as contained in The Circular. CFOs are responsible for the preparation of annual financial statements. Consequently, it can be argued that CFOs are representative of the preparers of the annual financial statements. Similarly, one of the roles of investment analysts' (also referred to as stockbrokers) communities is to give advice on the buy/sell decisions of the investors. Therefore, it can be argued that investment analysts are representative of the users of financial statements.

Some of the ratios used in analysing the financial results include EPS, HEPS and P/E ratios. As a result, it would be expected that both the CFOs and investment analysts would have adequate knowledge about the subject.

3.5 SAMPLE

As stated above, a sample represents a selected group of the population to be used for the study that is to be considered representative of the population (Hofstee, 2009:122). This study was based on the total population of investment analysts and CFOs of the real estate investment and services entities. The study focuses on JSE listed investment property entities. This sector is called Real Estate - Real Estate Investment and Services. As at 25 March 2013, there were twenty-six entities listed in this sector. All entities, which are suspended from the JSE, are excluded from the list. The following is a list of the entities that were listed in the Real Estate Investment and Services sector (Sharedata, 2013) at that date:

Table 3.2 Sample

Real Estate Investment and Services sector entities			
No.	**Entity Name**	**Market Capitalisation (Rm)**	**FV policy?**
1	Acucap Properties Ltd	8 772	Yes
2	Adrenna Property Group Ltd	21	Yes
3	Annuity Properties Ltd	1 078	Yes
4	Arrowhead Properties Ltd	3 026	Yes

No.	Entity Name	Market Capitalisation (Rm)	FV policy?
5	Ascension Properties Ltd	1 647	Yes
6	Capital and Counties Properties PLC	28 528	Yes
7	Delta Property Fund Ltd	1 953	Yes
8	Dipula Income Fund Ltd	2 889	Yes
9	Fairvest Property Holdings Ltd	405	Yes
10	Fortress Income Fund Ltd	6 699	Yes
11	Growthpoint Properties Ltd	48 052	Yes
12	Hospitality Property Fund Ltd	2 918	Yes
13	Hyprop Investments Ltd	17 905	Yes
14	Ingenuity Property Investments Ltd	739	Yes
15	Investec Property Fund Ltd	5 155	Yes
16	New Europe Property Investments plc	9 181	Yes
17	Octodec Investments Ltd	2 208	Yes
18	Premium Properties Ltd	2 806	Yes
19	Putprop Ltd	207	Yes
20	Rebosis Property Fund Ltd	3 686	Yes
21	Redefine Properties International Ltd	3 529	Yes
22	Resilient Property Income Fund Ltd	15 346	Yes
23	Synergy Income Fund Ltd	1 276	Yes
24	Vividend Income Fund Ltd	1 047	Yes
25	Vukile Property Fund Ltd	7 910	Yes
26	Vunani Property Investment Fund Ltd	1 269	Yes

The preparers of the annual financial statements are tasked with the overall responsibility of interpreting the requirements of the accounting standards in order to apply them in the preparation of the annual financial statements. Entities rely on their CFOs to prepare annual financial statements that comply with all the requirements of the accounting standards. The study requested feedback from CFOs of the above-mentioned entities to establish their views on principles-based versus rules-based headline earnings guidance.

The second part of the population included in this study is the investment analysts. As at 25 March 2013, there were sixty-one investment analysts approved by the JSE and they are listed below (JSE, 2013):

Table 3.3 Investment analysis

JSE approved investment analysts	
1	28E Capital (Pty) Ltd
2	ABSA Capital Securities (Pty) Ltd
3	ABSA Stockbrokers (Pty) Ltd
4	Afrifocus Securities (Pty) Ltd
5	Anglorand Securities Ltd
6	Avior Research (Pty) Ltd
7	BNP Paribas Cadiz Stockbroking (Pty) Ltd
8	B.P.Bernstein (Pty) Limited
9	BPI Capital Africa (Pty) Ltd
10	Brockhouse Cooper SA (Pty) Ltd
11	Citigroup Global Markets (Pty) Ltd
12	CKS Equities (Pty) Ltd
13	Computershare Outsourcing Limited
14	Consilium Securities (Pty) Ltd
15	Constant Capital (Pty) Ltd
16	Cratos Capital (Pty) Ltd
17	Credit Suisse Securities JHB (Pty) Ltd

JSE approved investment analysts	
18	Deutsche Securities (Pty) Ltd
19	Dynamic Wealth Stockbrokers (Pty) Ltd
20	FFO Securities (Pty) Ltd
21	Finsettle Services (Pty) Ltd
22	FNB Securities (Pty) Ltd
23	Golding Torr and De Decker (Pty) Ltd
24	HSBC Securities (South Africa) (Pty) Ltd
25	Imara SP Reid (Pty) Ltd
26	Investec Securities (Pty) Ltd
27	J P Morgan Equities South Africa (Pty) Ltd
28	Kagiso (KSL) Online Share Trading
29	Kagiso Securities Ltd
30	Lefika Securities (Pty) Ltd
31	Legae Securities (Pty) Ltd
32	Macquarie First South Securities (Pty) Ltd
33	Merrill Lynch South Africa (Pty) Ltd
34	Navigare Securities (Pty) Ltd
35	Nedgroup Private Wealth Stockbrokers (Pty) Ltd
36	Nedgroup Securities (Pty) Ltd
37	Noah Capital Markets (Pty) Ltd
38	NVest Securities (Pty) Ltd

JSE approved investment analysts	
39	Online Securities Ltd also known as PSG Online
40	Peregrine Equities (Pty) Ltd
41	Philippus De Witt (Pty) Ltd
42	Prescient Securities (Pty) Ltd
43	Prime Securities (Pty) Ltd
44	Regiments Securities Ltd
45	Rencap Securities (Pty) Ltd
46	RMB Morgan Stanley (Pty) Ltd
47	RMB Securities (Pty) Ltd
48	RMB Stockbroking Operations (Pty) Ltd
49	SA Stockbrokers (Pty) Ltd
50	Sanlam Private Investments (Pty) Ltd
51	Sasfin Securities (Pty) Ltd
52	SBG Securities (Pty) Ltd
53	Syfrets Securities Limited
54	Taquanta Securities (Pty) Ltd
55	TFS Securities (Pty) Ltd
56	Thebe Stockbroking (Pty) Ltd
57	UBS South Africa (Pty) Ltd
58	Vector Equities (Pty) Ltd
59	Vunani Securities (Pty) Ltd

JSE approved investment analysts	
60	Watermark Securities (Pty) Ltd
61	WWC Securities (Pty) Ltd

3.6 SUMMARY AND CONCLUSION

The Circular provides for general rules on what should be included and excluded from the headline earnings calculation. In cases where the industry group believes that the general rule results in information that does not provide information useful to their respective users, such an industry group is requested to make a representation to the JSE stating that fact (SAICA, 2013:21). If no representation is made, it is assumed that the rules stated in The Circular are appropriate in reflecting a true and fair view of the economic performance of all entities. An example of an industry group that made a representation is the life insurance industry.

The life insurance industry argued in their representation that the exclusion of fair value adjustments of investment properties from the calculation of headline earnings distorts the performance of those entities. Consequently, The Circular makes special provision for life insurance entities stating that the fair value adjustments of all life insurance entities are specifically included in headline earnings. What is unclear from The Circular is whether entities in a conglomerate can apply more than one rule (i.e. include fair value adjustments for life insurance entities and exclude fair value adjustments for the rest of the entities in the group) in their consolidated financial statements or if these entities need to apply one rule. If entities in a conglomerate were required to only apply one rule, would it be the general rule or the special provision.

In addition, it is not clear if the industries that did not make a representation to have a special provision created, believed that the application of the general rule in the preparation of their annual financial statements resulted in a true and fair view of their financial results. Real estate investment and services entities' ordinary activities involve holding investment properties, which means that the majority of income is generated from rental income and fair value gains or losses. Therefore, it can be argued that the exclusion of fair value gains or losses from calculation of the headline earnings of investment property entities is likely to result in material omissions of earnings.

The total population, which includes both listed investment property entities and investment analysts, was selected for the purpose of the study and both groups were asked the same questions. The participants were asked if they strongly agreed, agreed, neutral, disagreed or strongly disagreed with the statement or question that was asked.

One of the limitations of this study is that the researcher was not able to ask follow up questions for clarity, nor observe body language or interact with the participants.

3.6.1 Summary of Chapter 3

Table 3.4 A visual summary of Chapter 3:

<table>
<tr><td colspan="2" align="center">Introduction</td></tr>
<tr><td>Research methods:
– Survey-based approach; and
– Questionnaire.</td><td>Limitation:
– No face to face interactions.</td></tr>
<tr><td>Population:
– Twenty-six CFO of listed property entities; and
– Sixty-one Investment analysts</td><td>Sample:
– Eighty-seven participants in total; and
– Comprising CFO’s and investment analysts.</td></tr>
<tr><td colspan="2" align="center">Summary and conclusion</td></tr>
</table>

Chapter 4: Analysis of Results

4.1 RESULTS SUMMARY

The purpose of this study is to determine the appropriateness of rules-based headline earnings guidance for listed property entities on the JSE. The study follows a survey-based approach, which required that all participants be asked the same set of questions. The population comprised two groups that were the chief financial officers (CFOs) of the real estate investment and services entities and the investment analysts approved by the JSE. The total population was eighty-seven, which included twenty-six Real Estate Investment Entities and sixty-one investment analysts.

The overall response rate was twenty-four per cent (twenty-one responses), which is lower than was hoped for. The response rate for each of the groups within the population can be summarised as follows: twenty-five per cent (fifteen responses) of the total investment analysts' group completed the survey while twenty-three per cent (six responses) from the CFOs group participated. The majority of the participants' age range is between thirty and thirty-nine (sixty-seven per cent or fourteen responses) and the rest are between twenty-one and twenty-nine (nineteen per cent or four responses), there is one respondent each (or five per cent) in the age range of forty to forty-nine and sixty or older. Given that the sample is small, the analysis below follows a descriptive statistics method. The descriptive statistics method involves an interpretation of the data to provide meaning to the participants' responses (Sandelowski, 2000:336). In this study, this method was useful in interpreting the responses from the participants in the context of the research question.

The participants were asked to indicate their level of agreement/disagreement on a five point Likert scale indicating whether the Conceptual Framework's qualitative characteristics were likely to be achieved using principles-based headline earnings guidance, or rules-based headline earnings guidance. A Likert scale allows a researcher to collect data reflecting degrees of opinion. A Likert scale is a reliable measurement scale to assess a participant's attitudes by providing answer choices, ranking from one extreme to another, and not only “Yes” or “No” answers (Likert Scale for Rating Questionnaire Responses, 2015). The five-point Likert scale consists of the following: strongly disagree, disagree, neutral, agree and strongly agree. However, the discussion below has been summarised as follows: Strongly agree and agree responses have been combined and discussed as, agree. Similarly, strongly disagree and disagree responses have been combined and referred to as disagree.

The research instrument is included in the Appendix to this document. Overall responses indicated that there is a preference for principles-based headline earnings guidance. For example, in analysing the fundamental characteristics, the results indicate that principles-based headline earnings guidance is preferred in providing financial information, which are relevant and faithfully represented. Sixty-seven per cent of all participants believe that principles-based headline earnings guidance is likely to provide relevant information compared to forty-three per cent of the participants who consider that rules-based headline earnings guidance provides for relevant financial information. Similarly, sixty-two per cent of all participants believe that principles-based headline earnings guidance is likely to faithfully represent the financial information while forty-seven per cent believe that rules-based headline earnings guidance is capable of providing financial information faithfully. However, rules-based headline earnings guidance is the preferred guidance for providing financial statements that are materially correct. Fifty-three per cent of all participants believe that principles-based headline earnings guidance is likely to result in a misstatement of financial information while thirty-eight per cent of all participants believe that rules-based headline earnings guidance is likely to misstate financial information.

In respect of the enhancing characteristics, in which was included the subset characteristic of consistency, there is no consensus when it came to a clear indication of whether principles-based headline earnings guidance or rules-based headline earnings guidance was preferred. The responses indicate that principles-based headline earnings is preferred in two of the five characteristics, which are consistency and understandability, while rules-based headline earnings guidance is preferred in the other two, which are comparability and verifiability. The results on comparability and verifiability are consistent with some of the reasons for US GAAP not wanting to move from the current rules-based to a principles-based guidance. For example, it is argued that a lack of detailed guidance in the principles-based accounting standards may result in the manipulation of financial statements which would result in financial results which are not comparable from one entity to another (Agoglia, *el al*, 2011:748). The high level guidance provided in the principles-based accounting guidance may lead to different interpretations by more than one professional presented with the same information, which may make financial information difficult to verify (Benston, *et al,* 2006:170).

The results show that both principles-based headline earnings and rules-based headline earnings guidance are believed to be equally capable of providing timely information.

In addition, the results show that principles-based headline earnings guidance is believed to allow for both the auditors and the preparers of the financial statements to use professional judgement in deciding whether an accounting treatment is more likely to better reflect an economic reality, than when using rules-based headline earnings guidance.

Lastly, the majority of the participants believe that the application of principles-based headline earnings guidance is likely to be more cost-effective than rules-based headline earnings guidance.

The two groups were split and analysed separately to evaluate if there is a common preference between the investment analysts and CFOs. The results show that in all the sections discussed below investment analysts prefer principles-based headline earnings guidance to rules-based headline earnings guidance. Similarly, the results revealed that the CFOs believe that principles-based headline earnings is likely to provide better guidance than rules-based headline earnings guidance other than in the case of fundamental characteristics where the results were inconclusive.

The rest of the chapter is organised into five main sections. The first section discusses the fundamental qualitative characteristics. The second section discusses the enhancing qualitative characteristics. The third section discusses the role of the auditors. The fourth section discusses costs versus benefits. The last section contains the summary and conclusion.

4.2 FUNDAMENTAL QUALITATIVE CHARACTERISTICS

The results from the combined participants indicate that fundamental characteristics are best met if principles-based headline earnings guidance is applied rather than if rules-based headline earnings guidance in assessing relevance and faithful representation. However, the results indicate that the calculation of headline earnings is unlikely to be materially misstated if rules-based headline earnings guidance is applied, than using principles-based headline earnings guidance.

An analysis of the CFOs' responses separately from those of the investment analysts show that the CFOs believe that principles-based headline earnings guidance is better than rules-based headline earnings guidance in providing information, which is relevant. However, CFOs believe that rules-based headline earnings guidance is less likely to result in material misstatements of financial information compared to principles-based headline earnings guidance. In respect of the faithful representation principle, CFOs did not have a preference between principles-based headline earnings guidance and rules-based headline earnings guidance. In summary, the results relating to the fundamental characteristics are inconclusive with respect to whether CFOs prefer rules-based headline earnings guidance or principles-based headline earnings guidance.

The results of the show that investments analysts prefer principles-based headline earnings guidance compared to rules-based headline earnings guidance when assessing relevance and faithful representation. However, the investment analysts prefer rules-based headline earnings guidance with respect to providing information that is less likely to be materially misstated. In summary, it can be concluded that the investment analysts' believe that principles-based headline earnings guidance is more likely to achieve the fundamental characteristics than rules-based headline earnings guidance.

4.2.1 Relevance

Relevant information is information that if it is provided it is capable of making a difference to a decision (IASB, 2014:A29). In this case, participants were asked which approach they believe provided more relevant information between rules-based headline earnings guidance and principles-based headline earnings guidance.

Sixty-seven per cent of all the combined participants believe that principles-based headline earnings guidance is likely to provide relevant information while forty-three per cent of all the combined participants believe that rules-based headline earnings guidance will provide relevant information. These results indicate that the current headline earnings guidance, which is largely rules-based, is less likely to provide relevant information. This suggests that there is a need to review the current guidance in order to move closer to a principles-based guidance.

When analysing the results of the two groups separately, the results show that sixty-seven per cent of the investment analysts and an equal percentage of the CFOs believe that principles-based headline earnings guidance is more likely to provide relevant information. In contrast, fifty per cent of the CFOs and forty per cent of the investment analysts believe that rules-based headline earnings guidance is likely to provide relevant information. These results indicate that in the case of relevance both the CFOs and the investment analysts prefer principles-based headline earnings guidance to the rules-based headline earnings guidance. The table below summarises the abovementioned results:

Table 4.1 Summary of responses to the relevance question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based	67%	24%	9%	67%	33%	0%	67%	20%	13%
Rules-based	43%	19%	38%	50%	17%	33%	40%	20%	40%

Overall, the above results indicate that a principles-based approach is the preferred approach in providing relevant information. This result is consistent with the McEnroe and Sullivan (2012) study which found that eighty-seven per cent of the participants believed that relevance is likely to be achieved with a principles-based approach as compared to seventy-one per cent who believed that a rules-based approach can also provide relevant information (McEnroe & Sullivan, 2012:35).

4.2.2 Materiality

Financial information is material if by omitting it or misstating it, it could influence the decisions made by the users based on the financial information about a specific reporting entity (IASB, 2014:A30). In this case, participants were asked if they believe rules-based headline earnings guidance is likely to result in the omission/misstatement of material information or if they believe principles-based headline earnings guidance is likely to result in the omission/misstatement of material information.

The result showed that fifty-three per cent of all the participants believe that financial information is more likely to be misstated if principles-based headline earnings guidance while thirty-eight per cent of the participants believed that rules-based headline earnings guidance is likely to result in the misstatement of material information. From the above it seems that, when providing users of the financial statements with financial information that will assist them in making economic decisions, rules-based headline earnings guidance is preferred to principles-based headline earnings guidance.

When analysing the results of the two groups separately, the results show that fifty-four per cent of the investment analysts and fifty per cent of the CFOs believe that principles-based headline earnings guidance is likely to result in the material misstatement of financial information. In contrast, forty-six per cent of the investment analysts and only seventeen per cent of the CFOs believe that rules-based headline earnings guidance is also likely to result in the material misstatement of financial information. Therefore, the above results suggest that in order to avoid material misstatements in the financial statements rules-based headline earnings guidance is preferred by both the investment analysts and the CFOs. The table below summarises the abovementioned results:

Table 4.2 Summary of responses to the materiality question

	Combined participants			CFOs			Investment analysts		
	Agree	**Neutral**	**Disagree**	**Agree**	**Neutral**	**Disagree**	**Agree**	**Neutral**	**Disagree**
Principles-based	53%	19%	28%	50%	17%	33%	54%	20%	26%
Rules-based	38%	19%	43%	17%	33%	50%	46%	14%	40%

The usefulness of headline earnings in making an economic decision is sometimes questioned, particularly within the property industry. Growthpoint in its 2013 annual report stated the following: *"The directors are of the view that the disclosure of earnings per share set out below, while obligatory in terms of IAS 33 Earnings per share and the JSE Listings Requirements, is not meaningful to investors as the shares are traded as part of a linked unit…."* (Growthpoint annual report, 2013:35) This suggests that the earnings per share number has been disclosed purely to comply with the stated rules as the disclosure thereof does not influence the investors' decision-making. Some participants who volunteered to share their experiences over and above completing the survey shared similar sentiments. These participants stated that headline earning is not the main focus in the property industry sector. Instead, the industry focuses on the distribution yield (cash flow) and net asset value (NAV) per share. Therefore, it can be argued that a valuation method such as the price earnings ratio (P/E) is not relevant to the property industry. It can be argued that the omission of headline earnings information in the financial statements of entities in this industry is unlikely to impact users' economic decision-making. Therefore, headline earnings information is not material enough to warrant disclosure for the property industry group and maybe this industry needs to be exempted from providing this information in their financial reports.

If rules-based headline earnings guidance is adopted, then a special rule should be created to exclude the property industry group from providing headline earnings disclosure. Instead, this industry should be requested to disclose the NAV per share in their financial statements. In addition, guidance around distribution yield and NAV will then need to be provided to ensure a consistent approach is being applied across the property industry group. However, if a principles-based approach is followed, entities should be requested to provide only information that the preparers of the financial statements deem to be appropriate to the users of the financial information and that is useful in decision-making.

In summary, the above results indicate that rules-based headline earnings guidance is preferred to prevent the misstatement of material information.

4.2.3 Faithful representation

Accounting information is a faithful representation when it is complete, neutral, and free from error. A complete depiction of financial information means that all necessary information is disclosed including all descriptions and explanations in order to ensure that the users' understand the financial information (IASB, 2014: A30).

Participants were asked to state if they believed that principles-based headline earnings guidance or rules-based headline earnings guidance is more likely to provide faithful representation. The overall results indicated that sixty-two per cent of all participants believed that principles-based headline earnings guidance is more likely to provide faithful representation, while forty-seven per cent of all participants believed that rules-based headline earnings guidance is also likely to provide financial information faithfully. Therefore, it can be concluded that in the case of faithful representation, principles-based headline earnings guidance is better than the rules-based headline earnings guidance.

An analysis of the two separate groups revealed that sixty per cent of the investment analysts and sixty-six per cent of the CFOs believe that principles-based headline earnings guidance is more likely to faithfully represent the financial performance and position of an entity. In contrast, forty per cent of the investment analysts and sixty-seven per cent of the CFOs believe that rules-based headline earnings guidance is also likely to provide faithful representation. These results indicate that in the case of faithful representation, the investment analysts prefer principles-based headline earnings guidance to rules-based headline earnings guidance while the CFOs do not have a preference. The table below summarises the abovementioned results:

Table 4.3 Summary of responses to the faithful representation question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based guidance	62%	14%	24%	66%	34%	0%	60%	7%	33%
Rules-based guidance	47%	24%	29%	67%	16%	17%	40%	27%	33%

The above results indicate that principles-based headline earnings guidance is preferred in achieving faithful representation.

4.3 ENHANCING QUALITATIVE CHARACTERISTICS

Enhancing qualitative characteristics are those characteristics that enhance the usefulness of the provided financial information that is relevant, material and faithfully represented (IASB, 2014:A33). These characteristics are comparability, consistency, verifiability, timeliness and understandability. The overall results show that there is no preference between rules-based headline earnings guidance and principles-based headline earnings guidance as far as the enhancing characteristics are concerned. Principles-based headline earnings guidance is preferred in providing consistent and understandable financial information. On the other hand, rules-based headline earnings guidance is preferred in providing comparable and verifiable financial information. There is no preference in providing timely information, as both approaches are equally preferred.

The results indicate that CFOs prefer principles-based headline earnings guidance in three of the five enhancing characteristics, which are consistency, verifiability and understandability. However, with respect to the remaining two enhancing characteristics, which are comparability and timeliness, the CFOs prefer rules-based headline earnings guidance.

On the other hand, investment analysts prefer principles-based headline earnings guidance in three of the five enhancing characteristics. Only in the case of one of the enhancing characteristics, which is verifiability the investment analysts prefer rules-based headline earnings guidance. The results indicate that the investment analysts do not have a preference with respect to comparability characteristics.

4.3.1 Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items (IASB, 2014:A34).

Overall results indicate that fifty-seven per cent of all participants believe that principles-based headline earnings is likely to provide the basis for useful comparisons while fifty-eight per cent believe that rules-based headline earnings is likely to provide the basis for useful comparisons. These results indicate marginal preference to rules-based headline earnings guidance in providing comparable financial information.

An analysis of the two groups reflect that fifty-three per cent of the investment analysts and sixty-six per cent of the CFOs believe that principles-based headline earnings guidance is likely to provide useful comparisons. In contrast, an equal percentage (fifty-three per cent) of the investment analysts and sixty-seven per cent of the CFOs believe that rules-based headline earnings guidance is also likely to result in useful comparatives. These results indicate that investment analysts do not have preference while there is marginal preference to rules-based headline earnings by the CFOs. The table below summarises the above-mentioned results:

Table 4.4 Summary of responses to the comparability question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based	57%	14%	29%	66%	17%	17%	53%	13%	34%
Rules-based	58%	14%	28%	67%	16%	17%	53%	13%	34%

In summary, the above results suggest that overall there is marginal preference to rules-based headline earnings guidance (fifty-eight per cent) compared to principles-based headline earnings (fifty-seven per cent) in providing information that is comparable between different entities. In addition, the above results indicate that investment analysts do not have preference between rules-based headline earnings guidance and principles-based headline earnings guidance while the CFOs marginally prefer rules-based headline earnings guidance to principles-based headline earnings guidance.

4.3.2 Consistency

Consistency implies that the entity applies the same accounting treatments to similar events from period to period (IASB, 2014:A34). Participants were asked if they believe principles-based headline earnings guidance or rules-based headline earnings guidance is likely to provide the basis for the consistent application of the accounting guidance from one period to another.

Overall results indicate that sixty-seven per cent of all the participants believe that principles-based headline earnings guidance is likely to provide consistency from one period to another while fifty-seven per cent of the participants believe that rules-based headline earnings guidance is also likely to provide consistent information from one period to another. The South African Institute of Chartered Accountants (SAICA) designing rules-based headline earnings guidance cited that *“the only way to achieve consistency is to create detailed rules for all items that are separately disclosable in terms of IFRS. Any deviation from the rules would result in undesirable inconsistencies. Entities are therefore not permitted to override a rule even if they believe that the operating/trading and platform distinction set out in the rules is inappropriate for their specific business.”* (SAICA 2013:8). The above results are inconsistent with SAICA’s assertion. This result reflects that consistency is better achieved with principles-based headline earnings guidance than with rules-based headline earnings guidance.

A separate analysis of the two groups separately indicated that sixty per cent of the investment analysts and eighty-four per cent of the CFOs believe that principles-based headline earnings is likely to provide the best basis for the consistent application of the headline earnings guidance from one period to another. In contrast, fifty-three per cent of the investment analysts and sixty-seven per cent of the CFOs also believe that rules-based headline earnings guidance is likely to provide the best basis for consistent application. These results indicate that both the investment analysts and CFOs prefer principles-based headline earnings guidance rather than rules-based headline earnings guidance. The table below summarises the above-mentioned results:

Table 4.5 Summary of responses to the consistency question

	Combined participants			CFOs			Investment analysts		
	Agree	**Neutral**	**Disagree**	**Agree**	**Neutral**	**Disagree**	**Agree**	**Neutral**	**Disagree**
Principles-based	67%	5%	29%	84%	0%	16%	60%	7%	33%
Rules-based	57%	29%	14%	67%	16%	17%	53%	33%	14%

In summary, the above results suggest that principles-based headline earnings guidance is preferred to rules-based headline earnings for providing consistent information. In addition, both the CFOs and investment analysts prefer principles-based headline earnings guidance to rules-based headline earnings guidance.

4.3.3 Verifiability

Accounting information is verifiable when independent measurers, using the same methods, obtain similar results (IASB, 2014:A32). This qualitative characteristic can also be read in conjunction with the role of auditors discussed in section 4.4 below.

The responses to the questionnaire indicate that sixty-two per cent of all the participants believe that principles-based headline earnings guidance is likely to provide verifiable information while seventy-two per cent of the participants believe that rules-based headline earnings guidance is likely to provide verifiable information.

An analysis of the two groups separately revealed that fifty-three per cent of the investment analysts and eighty-three per cent of the CFOs believe that principles-based headline earnings guidance is likely to provide verifiable information. In contrast, seventy-three per cent of the investment analysts and sixty-seven per cent of the CFOs believe that rules-based headline earnings guidance is likely to provide verifiable information. The table below summarises the above-mentioned results:

Table 4.6 Summary of responses to the verifiability question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based	62%	10%	28%	83%	0%	17%	53%	13%	33%
Rules-based	72%	10%	18%	67%	0%	33%	73%	13%	14%

In summary, the above results show that overall there is a preference for rules-based headline earnings guidance in providing verifiable information. This result is similar to the study of McEnroe and Sullivan (2012) who found that there is overwhelming support for a rules-based approach in providing verifiable information. Analyses of the two groups show that the CFOs prefer principles-based headline earnings guidance while the investment analysts prefer rules-based headline earnings guidance.

4.3.4 Timeliness

Timely information is available to decision-makers before it loses its capacity to make a difference (IASB, 2014:A33). In this case, participants were asked if they believe principles-based headline earnings guidance or rules-based headline earnings guidance is more likely to provide timely information.

Responses indicated that fifty-seven per cent of all participants believe that both principles-based headline earnings guidance and rule-based headline earnings are equally capable of providing timely information.

When analysing the results of the two groups separately, the results indicate that sixty per cent of the investment analysts and fifty per cent of the CFOs believe that principles-based headline earnings guidance is likely to provide timely information. On the other hand, fifty-four per cent of the investment analysts and sixty-seven per cent of the CFOs believe that rules-based headline earnings guidance is likely to provide timely information. In this case, these results indicated that the investment analysts prefer principles-based headline earnings guidance while CFOs prefer rules-based headline earnings guidance. This result can be interpreted to mean that timeliness has no bearing on whether guidance on headline earnings is rules-based or principles-based. The table below summarises the above-mentioned results:

Table 4.7 Summary of responses to the timeliness question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based	57%	19%	24%	50%	33%	17%	60%	13%	27%
Rules-based	57%	24%	19%	67%	16%	17%	54%	26%	20%

In summary, the above results indicate that there is no preference between principles-based headline earnings guidance and rules-based headline earnings guidance as far as providing timely information is concerned. However, an analysis of the two groups separately indicates that the investment analysts believe principles-based headline earnings is likely to results in timely information while the CFOs believe that rules-based headline earnings is likely to results in timely information.

4.3.5 Understandability

Classifying, characterising, presenting information clearly, and concisely makes it understandable (IASB, 2014:A33). In this case, participants were asked if they believe principles-based headline earnings or rules-based headline earnings guidance is likely to make financial information understandable.

Overall results indicate that sixty-seven per cent of all the participants believe that principles-based headline earnings is likely to make financial information understandable while fifty-three per cent of all participants believe that rules-based headline earnings is likely to make financial information understandable.

An analysis of the two groups separately revealed that sixty per cent of the investment analysts and eighty-three per cent of the CFOs believe that principles-based headline earnings guidance is likely to make financial information understandable. However, forty-seven per cent of the investment analysts and sixty-seven per cent of the CFOs believe that rules-based headline earnings guidance is also likely to make financial information understandable. The table below summarises the above-mentioned results:

Table 4.8 Summary of responses to the understandability question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based	67%	10%	23%	83%	0%	17%	60%	13%	27%
Rules-based	53%	14%	33%	67%	0%	33%	47%	20%	23%

In summary, the above results indicate that principles-based headline earning guidance is preferred in order to provide and present financial information in a clear and concise manner. A closer analysis of the two groups separately indicated that both the investment analysts and CFOs believe that principles-based headline earnings guidance is likely to make financial information more understandable than rules-based headline earnings.

4.4 ROLE OF THE AUDITORS

The entity and its auditor use professional judgement in considering whether the accounting representation is consistent with the actual economic substance. Participants were asked to respond whether they believe that rules-based headline earnings guidance is likely to provide for the professional judgement or if they believe principles-based headline earnings guidance is likely to achieve this objective instead.

The overall response indicates that eighty-one per cent of all participants believe that principles-based headline earnings guidance is likely to provide for professional judgement while thirty-three per cent believe that rules-based headline earnings guidance is also likely to provide for professional judgement.

A separate analysis of the two groups indicates that seventy-three per cent of the investment analysts and one hundred per cent of the CFOs believe that principles-based headline earnings guidance encourages the use of professional judgements. However, thirty-three per cent of the investment analysts and an equal percentage of CFOs also believe that rules-based headline earnings guidance is also likely to encourage the use of professional judgement. The table below summarises the above-mentioned results:

Table 4.9 Summary of responses to the professional judgement question

	Combined participants			CFOs			Investment analysts		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Principles-based	81%	14%	5%	100%	0%	0%	73%	20%	7%
Rules-based	33%	19%	48%	33%	17%	50%	33%	20%	47%

The above results indicate support for principles-based headline earnings guidance in so far as encouraging the use of professional judgement. In a similar vein the study of McEnroe and Sullivan (2012:35) found that ninety-one per cent of the participants believe that principles-based accounting standards are likely to encourage the use of professional judgement as compared to fifty-six per cent of the participants who believed that rules-based accounting standards are likely to encourage the use of professional judgement.

Based on the above evidence, it can be argued that principles-based headline earnings guidance is likely to encourage the use of professional judgement. Consequently, the use of professional judgement is likely to provide financial results that better reflect the economic reality of entities than a rules-based guidance. Alexander and Jermakowicz (2006:132) who found that CFOs know their business better, and should be allowed to reflect the financial results in a manner that best reflects the economic reality of their business further support this view. Similarly, in this study both the investment analysts and CFOs showed support for principles-based headline earnings guidance above rules-based headline earnings guidance.

4.5 COSTS VERSUS BENEFITS

Cost is a significant constraint on financial reporting (IASB, 2014:A35). It is important that the costs are justified by the received benefits of reporting the financial information (IASB, 2014:A35). Participants were asked which approach between rules-based headline earnings guidance and principles-based headline earnings guidance is likely to be cost-effective in the development of useful financial information.

The overall responses indicated that fifty-seven per cent of all the participants believe that principles-based headline earnings guidance is likely to be cost-effective while twenty-nine per cent believe that rules-based headline earnings guidance is likely to be cost-effective. The aforementioned results show that principles-based headline earnings guidance is perceived to be more cost effective than a rules-based headline earning guidance.

A separate analysis of the two groups indicates that sixty per cent of the investment analysts and fifty per cent of the CFOs believe that principles-based headline earnings guidance is likely to be more cost-effective. In contrast, forty per cent of the investment analysts and nil per cent of the CFOs believe that rules-based headline earnings guidance is likely to be cost effective. The table below summarises the above-mentioned results:

Table 4.10 Summary of responses to the costs versus benefits question

	Combined participants			CFOs			Investment analysts		
	Agree	**Neutral**	**Disagree**	**Agree**	**Neutral**	**Disagree**	**Agree**	**Neutral**	**Disagree**
Principles-based	57%	14%	29%	50%	33%	17%	60%	7%	33%
Rules-based	29%	38%	33%	0%	67%	33%	40%	27%	23%

In summary, the above results indicate that the results of the combined groups revealed that principles-based headline earnings guidance is perceived to be the most cost-effective method in providing financial information to users of the financial statements. In addition, the results of the analysis of each group separately show that both the investment analysts and CFOs believe that principles-based headline earnings guidance is likely to be more cost effective than rules-based headline earnings guidance.

4.6 SUMMARY AND CONCLUSION

This study examines the appropriateness of rules-based headline earnings guidance by focussing on the qualitative characteristics of financial reporting as disclosed in the revised Conceptual Framework. According to the IASB, the Conceptual Framework should be used as the basis for all standard-setting processes. Whether a standard meets the objective of financial reporting should therefore be assessed to establish whether such a standard meets the intended objective, which is to provide financial information to users of the financial statements that is useful in assisting them to make economic decisions.

The Conceptual Framework's qualitative characteristics are split into fundamental characteristics and enhancing characteristics. Fundamental qualitative characteristics address the following: relevance, materiality and faithful representation of financial information. The responses from all participants indicate that principles-based headline earnings guidance is preferred in providing financial information that is relevant and represented faithfully. However, rules-based headline earnings guidance is preferred in providing financial statements that are materially correct.

Enhancing qualitative characteristics include comparability, consistency, verifiability, timeliness and understandability. In respect of the enhancing characteristics, there is no consensus. The responses indicate that principles-based headline earning guidance is preferred for providing consistent and understandable financial information while rules-based headline earnings guidance is preferred for providing comparable and verifiable financial information. Principles-based headline earnings guidance and rules-based headline earnings guidance are believed to be equally capable of providing timely information.

Finally, the chapter discussed the costs versus benefits principles of disclosing financial information. The majority of the participants believe that principles-based headline earnings guidance is likely to be more cost-effective than rules-based headline earnings guidance. In summary, the results show that in analysing the combined responses, there is preference for principles-based headline earnings guidance over rules-based headline earnings guidance. Given that the current guidance is largely rules-based guidance, these results suggest that there is a need to review the current guidance to make it more principles-based.

The two groups were split and analysed separately, to evaluate if there is a common preference between the investment analysts and CFOs. The results show that in all the sections discussed above investment analysts prefer principles-based headline earnings guidance rather than rules-based headline earnings guidance. Similarly, the results revealed that the CFOs believe that principles-based headline earnings are likely to provide better guidance than rules-based headline earnings guidance.

In conclusion, the above results support the view that headline earnings guidance should be principles-based rather than rules-based which is contrary to the current guidance. SAICA, in arriving at the conclusion that rules-based headline earnings guidance is better, stated that the only way to achieve consistency in financial statement is to introduce rules, which is contrary to the above results. The above results show that consistency is better achieved with principles-based headline earnings guidance than rules-based headline earnings guidance. Therefore, it is recommended that SAICA reconsider their position in deciding whether to adopt principles-based headline earnings guidance or rules-based headline earnings guidance.

4.6.1 Summary of Chapter 4

Table 4.11 A visual summary of the results from the total combined population:

Introduction	
Fundamental characteristics: • Relevance: sixty-seven per cent prefer principles-based headline earnings guidance compared to forty-three per cent that support rules-based headline earnings guidance; • Material misstatements of financial statements: fifty-three per cent believe principles-based headline earnings guidance is likely to result in material misstatement compared to thirty-eight per cent believe rules-based headline earnings guidance will do so; and	**Enhancing characteristics:** • Comparability: fifty-seven per cent prefer principles-based headline earnings guidance compared to fifty-eight per cent that support rules-based headline earnings guidance; • Consistency: sixty-seven per cent prefer principles-based headline earnings guidance compared to fifty-seven per cent that support rules-based headline earnings guidance; • Verifiability: sixty-two per cent prefer principles-based headline earnings guidance compared to seventy-two per cent that support rules-based headline earnings guidance;

• Faithful representation: sixty-two per cent prefer a principles-based headline earnings guidance compared to forty-seven per cent that support rules-based headline earnings guidance.	• Timeliness: No preference; and • Understandability: sixty-seven per cent prefer principles-based headline earnings guidance compared to fifty-three per cent that support rules-based headline earnings guidance.
Role of the auditors: eighty-one per cent prefer principles-based headline earnings guidance compared to thirty-three per cent that support rules-based headline earnings guidance.	
Costs versus benefits: fifty-seven per cent prefer a principles-based headline earnings guidance compared to twenty-nine per cent that support a rules-based headline earnings guidance.	
Summary and conclusion Overall conclusion: Principles-based headline earnings guidance is preferred to the current rules-based headline earnings guidance.	

Chapter 5: Summary and Conclusions

5.1 INTRODUCTION AND RECOMMENDATIONS

Headline earnings per share (HEPS) is a widely accepted South African performance measure. The objective of headline earnings as set out in the SAICA Circular 2/2013 (The Circular) is to create the basis for calculating headline earnings from operating/trading activities of an entity. In order to facilitate this, SAICA believes that the only way to achieve consistency in the reporting of headline earnings, is to create rules that every entity should apply. Any deviation from these created rules, even if the entities believe that such a deviation from the rules will result in headline earnings that are more representative of the operating/trading activity of those entities, should not be allowed (SAICA, 2013:8).

The only exception stated in The Circular is one that provides for an industry group that believes that some of the rules are not applicable to the entire industry, in which case such an industry group may make a representation to SAICA and the JSE to have separate rules created for such an industry group. An example of such an industry group with special rules is Life Insurance entities. One of the general rules included in The Circular is that fair value adjustments relating to investment properties are excluded from the headline earnings calculation. However, the Life Insurance industry made representations to SAICA and the JSE to have this rule amended for this industry, which means that the fair value adjustments of investment properties relating to the Life Insurance industry group are included in the headline earnings calculation.

The fact that SAICA requires an industry group to make a representation if they believe that the general rule does not address the industry specific needs, presupposes that an industry group who does not make the same application agrees with the general rule, which may not be the case. In some cases, it could be that HEPS may not be a major focus for a specific industry and the only reason for disclosure of such a number is to comply with the JSE listings requirements. A disclosure note included in Growthpoint's 2013 financial statements as noted in chapter 4 is a perfect example. Growthpoint noted that although EPS and HEPS were disclosed in their financial statements the main reason was for compliance purposes. The directors believed that these figures were not meaningful to their user groups (Growthpoint, 2013:35).

The Circular is unclear on which rule to apply in respect of consolidated financial statements that are prepared for a group of entities that comprise a Life Insurance entity and other entities which may not qualify for a special rule.

It is noted that Real Estate entities are not exempted from the general rule, which means that fair value adjustments of investment properties relating to this industry group are excluded from the headline earnings calculation. In addition, the term operating/trading activities is not clearly defined. The SAICA Circular 2/2013 defines operating/trading activities as *"those activities that are carried out using the "platform", including the cost associated with financing those activities."* (SAICA, 2013: 7). The platform is defined as *"the capital base of the entity. Capital transactions reflect and affect the resources committed in producing operating/trading performance and are not the performance itself."* (SAICA, 2013:7).

One view may be that the operating/trading activity of a Real Estate entity is to rent out properties or to hold them for capital appreciation. Therefore, one would expect that if the objective of headline earnings is to reflect the operating/trading earnings, the current rules-based headline earnings guidance does not reflect the intended objective for Real Estate entities, especially given that these entities are required to exclude the fair value adjustments of investment properties from their calculation of headline earnings in terms of the general rule. Growthpoint shared the same sentiment in their 2013 annual financial statements as stated above.

Furthermore, the fact that there are general rules that all entities are required to use and special rules for industry specific entities, raises the question of whether the current rules-based headline earnings guidance provides an acceptable basis for comparing HEPS from one entity to another, particularly in the case of entities operating in different industries subjected to different rules.

SAICA is an advocate of principles-based accounting standards. The evidence for this is the number of submissions made by SAICA to the IASB in response to the release of exposure drafts (ED) or discussion papers where SAICA encourages the IASB to continue setting accounting standards which are principles-based (SAICA, 2011:3). However, The Circular which is prepared by SAICA is rules-based, which is contrary to the standpoint they portray to the IASB.

5.2 RESEARCH PROBLEM

This study's research question is set out as follows:

Is a rules-based approach or a principles-based approach more appropriate for the calculation of headline earnings of listed property entities on the JSE Limited, for economic decision-making purposes?

5.3 RESEARCH OBJECTIVES

Besides the fact that headline earnings is such a popular measure of performance in South Africa, there are no scholarly studies to understand the appropriate basis on which headline earnings should be based, whether a rules-based approach or a principles-based approach. This study seeks to fill this gap.

5.4 SUMMARY OF RESEARCH RESULTS

The study followed a survey-based research method where a questionnaire was prepared with questions requiring participants to state their level of agreement with each statement raised. The questions were based on the qualitative characteristics of providing financial information as defined in the revised *Framework for the Preparation and Presentation of Financial Statements*. Specifically, questions required participants to make an assessment of which approach provided better financial information considering the fundamental characteristics and enhancing qualitative characteristics of providing financial information. The population included both investment analysts approved by the JSE and the CFOs of Real Estate entities. There were twenty-six approved investment analysts and sixty-one Real Estate entities on the JSE as at 25 March 2013, which is the date when the list was compiled.

All responses obtained were analysed in order to assess if there is an overall preference for either rules-based headline earnings guidance or principles-based headline earnings guidance. In addition, the two groups were then analysed separately to establish which approach the group of investment analysts preferred and which approach the group of CFOs preferred.

The IASB uses the Conceptual Framework as the basis for its standard setting process. The questionnaire was based on the principles established in the revised Conceptual Framework and on a study that was conducted by McEnroe and Sullivan (2012:36). This was considered to be particularly relevant given that the IASB is of the view that all accounting standards should be based on the Conceptual Framework. Headline earnings guidance is based on IFRS accounting standards, which are considered to be principles-based (SAICA, 2013:3; Agoglia, *et al,* 2011:747). This implies that the debate on the appropriateness of the current rules-based headline earnings guidance should consider the framework of setting accounting guidance and for all IFRS accounting guidance, that basis should be the Conceptual Framework. The questionnaire was divided into four main sections, which are the fundamental qualitative characteristics, the enhancing qualitative characteristics, the role of the auditors and the costs versus benefit of disclosure.

In total, only twenty-one responses out of a population of eighty-seven possible participants were received which equates to a twenty-four per cent response rate. The response rate for each of the two groups can be summarised as follows: twenty-five per cent (fifteen) of the total investment analysts' group of sixty-one possible participants completed the survey while twenty-three per cent (six) from the CFOs group of twenty-six possible participants participated.

The majority of the respondents supported principles-based headline earnings guidance over rules-based headline earnings guidance. In three of the sections considered above, the majority of the respondents believed that principles-based headline earnings guidance is better than rules-based headline earnings guidance. These three sections are the fundamental characteristics, the role of the auditors and costs versus benefits. No preference was expressed concerning the enhancing characteristics.

It is interesting to note that the main reason why SAICA opted for rules-based headline earnings guidance is that they believed it would lead to consistency in the reporting of headline earnings. This is contrary to the above results, which indicated that principles-based headline earnings guidance is more likely to result in consistency in the calculation of headline earnings than rules-based headline earnings guidance.

A separate analysis of the two groups revealed that in all four sections investment analysts preferred principles-based headline earnings guidance over rules-based headline earnings guidance. Similarly, the results revealed that the CFOs believe that principles-based headline earnings guidance is likely to provide better guidance than rules-based headline earnings guidance.

5.5 CONTRIBUTION TO THE BODY OF KNOWLEDGE

This study will be the first to challenge the approach used for headline earnings guidance. SAICA and the JSE's selection of a rules-based approach in setting the headline earnings guidance has been widely accepted without a study to understand the stakeholders' preferred approach between a rules-based approach and a principles-based approach.

Previous studies conducted by SAICA in 2006 only focussed on whether the various stakeholders believed that there was a need for headline earnings. Although the overall response from the participants supported the establishment of the headline earnings guidance, they were not asked about their preference of the basis to be used. Therefore, SAICA's study did not deal with the appropriateness of a rules-based approach compared to a principles-based approach.

It is expected that the findings of this study will raise debate on the subject matter, which is likely to encourage future studies on the subject.

5.6 LIMITATIONS OF THIS STUDY

A questionnaire was prepared and sent to participants requesting them to state their level of agreement/disagreement on a five point Likert scale to a statement or question raised. This methodology means that the researcher did not have the opportunity to ask follow up questions and assess respondents' body language, which may have enhanced the findings. Although some respondents voluntarily e-mailed their reasoning for their selections, they were not specifically requested to do so. A study that provides this opportunity (such as an interview) is likely to gather more qualitative information on the subject than was obtained in this instance.

The response rate could have been better than was achieved, only twenty-four out of eighty-seven participants responded to the questionnaire. The low response rate may have contributed to the current findings of this study.

5.7 CONCLUSION AND RECOMMENDATIONS FOR FUTURE STUDIES

This is the first known study aimed at establishing a preference between principles-based headline earnings guidance and rules-based headline earnings guidance. The data collected for this study indicates support for principles-based headline earnings guidance, which means that there is a need to review the current guidance with a view to create a principles-based guidance in line with the global trend.

The results show that sixty-seven per cent of all combined participants believe that relevance can be better achieved if a principles-based headline earnings approach is used compared to forty-three per cent who believe that rules-based guidance is better. In addition, the results show that sixty-two per cent of all combined participants believe that the financial statements are most likely to be faithfully represented if principles-based guidance is used compared to forty-seven per cent who are in favour of a rules-based approach. Fifty-three per cent of all combined participants believe that principles-based headline earnings guidance is likely to result in materially misstated information compared to thirty-eight per cent who believe that rules-based headline earnings will result in materially misstated financial information. Overall, the above results provide evidence that when evaluating the fundamental characteristics of providing financial information, principles-based headline earnings guidance is superior to rules-based headline earnings guidance.

The result is slightly different when considering the enhancing characteristics, which show there is no consensus. Principles-based headline earnings guidance is preferred in providing consistency and understandability. Sixty-seven per cent of all combined participants believe that consistency is likely to be achieved if a principles-based headline earnings guidance is used, compared to fifty-seven per cent who prefer rules-based guidance. Similarly, sixty-seven per cent believe that principle-based headline earnings guidance is likely to provide understandable financial information compared to fifty-three per cent who prefer rules-based guidance.

In contrast, rules-based headline earnings guidance is preferred in providing comparable and verifiable financial information. Fifty-eight per cent of all combined participants believe that rules-based headline earnings is likely to provide comparable financial information compared to fifty-seven per cent who prefer principles-based guidance. Seventy-two per cent of all combined participants believe that rules-based headline earnings is likely to result in verifiable financial information compared to sixty-two per cent who prefer principles-based guidance. When analysing timeliness characteristic, the results show an equal split (fifty per cent for each) between those who prefer principles-based headline earnings guidance and those who prefer rules-based headline earnings guidance.

Although this study provides evidence of the preference for principles-based headline earnings guidance, it does not address how such principles-based headline earnings guidance can be achieved. In addition, this study does not define principles within which the revised guidance can be based. For example, if headline earnings guidance is changed to a principles-based guidance from the current rules-based guidance, this study does not define the criteria to be used to decide whether an item of income or expense should be included or excluded in the headline earning calculation. It is recommended that this may be an area for future studies.

The population for this study was the investment analysts and the CFOs of listed Real Estate Investments and Services entities. In the future, the same study can be conducted by collecting data from the auditors. Similarly, another study may be done by collecting data from another industry sector other than the Real Estate Investments and Services industry sector and the results can be compared to this study.

Given that one of this study's limitations was the lack of interaction between the researcher and the participants, this study may be replicated using an interview approach rather than a Likert scale questionnaire. An interview approach is likely to provide for more qualitative insight into the preference for rules-based headline earnings guidance or principles-based headline earnings guidance.

Another area of future study may be to assess the relevance of headline earnings in the global context particularly given that South Africa is the only country that requires the disclosure of headline earnings for all listed entities. This study is critical particularly given that the P/E ratio of a South African entity can be calculated using the headline earnings in terms of the SAICA Circular 2/2013 or by using IAS 33 *Earnings Per Share* guidance provided by the IASB.

5.7.1 Summary of Chapter 5

Table 5.1 A visual summary of Chapter 5:

Introduction	
Research problem: • Is a rules-based approach or a principles-based approach more appropriate for the calculation of headline earnings of listed property entities on the JSE	**Research objectives:** • The study added to the current limited literature.

Limited for economic decision-making purposes.	
Summary of research results: • Principles-based headline earnings guidance is preferred to rules-based headline earnings guidance.	**Contribution to the body of knowledge:** • First study to question the basis for headline earnings - whether principles-based guidance or rules-based approach is preferred; • raises the debate on the subject; and • creates a base for future research studies.
Limitations of this study: – No face to face interactions between the researcher and the participants; and – Low response rate.	
Summary and conclusion	

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IFRS 9 *Financial Instruments*

IFRS 13 *Fair Value Measurement*

Conceptual Framework for Financial Reporting

IAS 2 *Inventories*

IAS 7 *Statement of Cash Flows*

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

IAS 33 *Earnings Per Share*

IAS 38 *Intangible Assets*

IAS 40 *Investment Property*

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Appendix A: Questionnaire

Purpose

The purpose of this study is to fulfil the requirements of a Masters in Philosophy in Accounting Science (MPhil Accounting Science) at the University of South Africa. The study focuses on listed investment property entities (sector described as the 'real estate investment and services' on the JSE Limited (JSE). The participants are the chief financial officers (CFOs) of these real estate investments and services sector entities as well as all the JSE approved investment analysts. Although participation is encouraged, it remains voluntary.

All responses will be treated with the highest level of integrity and no responses will be disclosed to any third party without the respondent consenting to such disclosure. Responses will be used in aggregate as the basis for concluding on the research, but none of the responses will be separately disclosed. Responses will be archived and destroyed after a period of a year.

The questionnaire is expected to take about five to ten minutes to complete.

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Background

The SAICA Circular 2/2013 Headline Earnings ("The Circular") is applicable to all entities listed on the JSE. The Circular makes provision for general rules, which are applicable to all entities and, industry specific rules for those industries that identify that a particular general rule does not address the specific issue related to the industry. In terms of the general rule, fair value adjustments of investment properties are excluded from headline earnings (refer to page 14 of The Circular). However, one of the specific rules relates to the fair value adjustments of investment property of life insurance entities, which allows such fair value adjustments to be included in the calculation of the headline earnings (refer to page 25 of The Circular). The main reason why the life insurance entities are exempted from the general rule is that the life insurance industry made a representation to SAICA and the JSE indicating that the general rule does not result in useful information to their users of the annual financial statements.

There is currently no exemption for the “Real Estate Investment and Services Industry”, which means that the fair value adjustments relating to their investment properties are excluded from headline earnings in terms of the general rule. The purpose of the questionnaire below is to determine your views regarding the appropriateness of the rules-based headline earnings guidance.

Fundamental characteristics are relevance and faithful representation. Relevant information constitutes material information, which is capable of making a difference in users’ economic decision making (IASB, 2014:A29). Enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability.

McEnroe and Sullivan (2012) investigated auditors and CFOs’ perceptions regarding which approach is preferred between a principles-based guidance and a rules-based approach. Rules-based accounting standards contain detail implementation guidance while principles-based accounting standards contain high level guidance (Sepehri & Houmes, 2011:59). The questionnaire used in McEnroe and Sullivan (2012) was based on the fundamental characteristics and enhancing qualitative characteristics.

This study seeks to determine the appropriateness of the rules-based headline earnings for listed property entities on the JSE Limited, which is a similar question as that raised in McEnroe and Sullivan (2012). As a result, this study follows the same approach followed by McEnroe and Sullivan (2012) and the questions were adapted from that study.

Which description best describes your position	Chief Financial Officer	Investment analysts

What is your age range:	18 to 20	21 to 29	30 to 39	40 to 49	50 to 59	60 or above

No.	Questions	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
	Fundamental Characteristics					
1	*Relevant information is information that is capable of making a difference in a decision*					
	A principle-based headline earnings guidance is likely to provide relevant information					
	A rules-based headline earnings guidance is likely to provide relevant information					
2	*Financial information is material if omitting it or misstating it could influence decisions that users make based on financial information about a specific reporting entity.*					
	A principle-based headline earnings guidance is likely to result in omission/misstatement of material information					
	A rules-based headline earnings guidance is likely to result in omission/misstatement of material information					
3	*Accounting information is a faithful representation when it is complete, neutral, and free from error*					
	Principle-based headline earnings guidance is likely to provide faithful representation					
	Rules-based headline earnings guidance is likely to provide faithful representation					
	Enhancing Characteristics					
4	*Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.*					
	Principles-based headline earnings guidance is likely to provide the basis for useful comparisons.					
	Rules-based headline earnings guidance is likely to provide the basis for useful comparisons.					
5	*Consistency implies that the entity applies the same accounting treatments to similar events from period to period.*					
	Principles-based headline earnings guidance is likely to provide for consistency from period to period.					
	Rules-based headline earnings guidance is likely to provide for consistency from period to period.					

No.	Questions	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
6	*Accounting information is verifiable when independent measurers, using the same methods, obtain similar results.*					
	Principles-based headline earnings guidance is likely to provide verifiable information.					
	Rules-based headline earnings guidance is likely to provide verifiable information.					
7	*Timely information is available to decision makers before it loses its capacity to make a difference.*					
	Principles-based headline earnings guidance is likely to provide timely information.					
	Rules-based headline earnings guidance is likely to provide timely information.					
8	*Classifying, characterising and presenting information clearly and concisely make it understandable.*					
	Principles-based headline earnings guidance is likely to make financial information understandable					
	Rules-based headline earnings guidance is likely to make financial information understandable					
	Role of auditors					
9	*The entity and its auditor use professional judgement in considering whether the accounting representation is consistent with the actual economic substance.*					
	Principles-based headline earnings guidance is likely to provide for professional judgement					
	Rules-based headline earnings guidance is likely to provide for professional judgement					
	General					
10	*Cost is a significant constraint on financial reporting.*					
	Principles-based headline earnings guidance is likely to be cost-effective in the development of useful financial information.					
	Rules-based headline earnings guidance is likely to be cost-effective in the development of useful financial information.					