The Effects of Regulations on Financial Information Systems of Public Companies in Israel on the Quality of their Financial Statements

Dan Amiram and Erez Bader

This study examines whether regulatory requirements introduced in 2009 that have standardized the ERP systems of public companies in Israel have a positive external effect on earnings quality. It is possible that the regulations of the Israeli tax authority, which require companies to manage their financial data in ERP software in a standardized way and are intended to improve tax collection, also reduce the ability of companies to manipulate financial reporting, and have a positive impact on earnings quality. On the other hand, financial reporting is based on many estimates, and limiting the biases in reporting to the tax authority does not necessarily affect the ability of managers to manipulate financial statements. For the purpose of examining our hypothesis, we examine whether, as a result of such regulation from 2009, there was an improvement in earnings quality. We do so by measuring earnings quality of Israeli companies using calculations based on Benford's Law. The results do not indicate an improvement in earnings quality after 2009, and are consistent with the alternative that managers have discretion in their financial reporting decisions and that earnings quality is not significantly affected by the tax reporting.