Research that Informs Standard Setting

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How does research inform?

- Research helps standard setters
  - Identify issues
  - Structure thinking
  - Provide reliable evidence
- Why academic research?
  - Concepts underlying financial reporting are comfortable for academic researchers
  - Conceptual input
  - Rigorous thinking and analysis
  - Unbiased; no stake in the outcome

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Research and standard setting

- Accounting standards are public goods and involve externalities
  - Desirability of accounting standards requires specifying social preferences
  - Even with market efficiency, relation to equity prices and returns is not sufficient to determine desirability or effects of particular standards

=> Operationalize *Framework* criteria

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Research and standard setting

- Standard setters select rules
- Research informs standard setting
- But, research cannot answer:

What should the standard be?

=> Motivating questions differ from research questions

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What research topics?

- Technical agenda topics
- Cross-cutting issues

Fair Value **Recognition/Disclosure** **Uncertainty/Risk**
Relevance/Faithful Representation **Incentives/Judgements**
Liabilities/Equity **User Needs** **Costs/Benefits**

- Conceptual framework
- Globalization of financial reporting

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IASB agenda

- Revenue
- Financial statement presentation
- Leases
- Post-employment benefits
- Fair value measurement
- Consolidation
- FI with characteristics of equity
- Emissions trading
- Conceptual framework
- Nonfinancial liabilities
- Insurance contracts
- Financial instruments
- Derecognition
- Management commentary
- Modifications to standards
  - Income taxes
  - Joint ventures

Fair value

- Fair value is considered whenever measurement is an issue – which is in almost all projects
- Current projects focused on measurement include
  - Fair value measurement
  - Conceptual framework
  - Financial instruments
  - Non financial liabilities (IAS 37)
  - Pensions – contribution-based promises
- Also …. revenue, insurance, leases …

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Research example #1

Fair Value Accounting for Liabilities and Own Credit Risk

M.E. Barth, L.D. Hodder, and S.R. Stubben
The Accounting Review 2008

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#1 Fair value accounting for liabilities and own credit risk

- Motivating questions
  - Do changes in credit risk affect a liability's fair value?
  - Would net income be misleading if effect were recognized?
- Research questions
  - Is effect of credit risk changes on equity returns mitigated by leverage?
  - How would income differ if fair values of debt were recognized?

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#1 Fair value accounting for liabilities and own credit risk

➢ *Is effect of credit risk changes on equity returns mitigated by leverage?*

- Research design
  - Estimate relation between equity returns and change in credit risk interacted with leverage
  - Estimate relation substituting estimate of debt gain or loss for interaction variable
  - Partition change in credit risk into change in expected asset cash flows and risk

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#1 Fair value accounting for liabilities and own credit risk

- Findings and interpretation
  - Equity returns less negative (positive) when credit risk increases (decreases) with more leverage
  - Most credit risk levels, even lowest
  - Attributable to asset cash flow and risk changes

=> Equity holders gain (lose) when credit risk increases (decreases) because of debt

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#1 Fair value accounting for liabilities and own credit risk

➢ *How would income differ if fair values of debt were recognized?*

- Research design
  - Invert Merton (1974) model to obtain estimates of asset and liability values
  - Restate net income to reflect all changes in fair values and only changes in debt fair values

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#1 Fair value accounting for liabilities and own credit risk

- Findings and interpretation
  - *All* value changes: decreases income for downgrade firms, opposite for upgrade
  - *Only* debt value changes: increases income for downgrade firms, opposite for upgrade
  - Recognized asset write-downs exceed debt value gains for most firms

=> Concerns about anomalous effects not unwarranted – but not pervasive

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Research example #2

Revaluations of Fixed Assets and Future Firm Performance: Evidence from the UK

D. Aboody, M.E. Barth, and R. Kasznik
Journal of Accounting and Economics 1999

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#2 Fixed asset revaluations and future performance

- Motivating questions
  - Are asset revaluation amounts reliable estimates of asset fair values?
  - Do managers exercise their discretion so as to render the fair value estimates unreliable?
- Research question
  - Do upward asset revaluations explain changes in future operating performance?

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#2 Fixed asset revaluations and future performance

- Research design
  - UK firms with upward asset revaluations
  - Incremental explanatory power in regression of change in realized future performance on revaluation amount, past change in performance
    - Future performance: One, two, and three year ahead operating cash flows and operating income
  - Also prices and returns
  - Permit relations to vary with debt-to-equity ratio

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#2 Fixed asset revaluations and future performance

- Findings
  - Revaluations significantly associated with changes in future operating performance
  - Revaluation balances associated with share prices, increments associated with returns
  - Relations less positive for higher debt-to-equity firms

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#2 Fixed asset revaluations and future performance

- Interpretation

  => Fair values of fixed assets are reliable as reflected in future performance

  => Changes in fair values are relevant to investors and reflect timely changes in asset values

  => Evidence of management discretion, but effects do not eliminate relevance or reliability

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Fair value research
What have we learned?

- Fair values are relevant and reliable enough to be reflected in investors' valuations
- Reliability of changes in fair values can be eroded by estimation error
- Managers opportunistically exercise discretion
- Changes in fair value of liabilities can be important to investors

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Fair value
Questions for research

- Can fair values provide a faithful representation? In all circumstances?
- Should we use fair value as the measurement basis? For some assets and liabilities, for all?
- What information do investors need about fair values? Estimation uncertainty?
- What complementary information is useful?
- Does recognition or disclosure matter?
- Are concerns about increased earnings volatility legitimate?

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Fair value
Questions for research

- What are effects of management discretion in determining fair values? More or less than with other measurement bases?
- Will use of more fair values affect investor or management behavior? What, why, and how?
- What are implications of incorporating more expectations about the future in financial statements today?
- How does more fair value change meaning of profit or loss? Is it a more or less useful measure of performance?

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IASB vision

…one single set of high quality global standards...

...used on the global capital markets.

Why global standards?

- Improve functioning of global capital markets
- Increase
  - Comparability, thereby reducing information processing costs
  - For many countries, quality of information
- Decrease
  - Costs of preparing financial statements, especially for multinational firms
  - Information risk and cost of capital

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Research example #3

Market Reaction to the Adoption of IFRS in Europe

C.S. Armstrong, M.E. Barth, A.D. Jagolinzer and E.J. Riedl
The Accounting Review 2010

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#3 IFRS adoption in Europe

- Motivating questions
  - Did investors perceive net benefits to adoption of IFRS in Europe?
  - Convergence or increased quality?
- Research questions
  - Did European market react positively (negatively) to events that increased (decreased) likelihood of IFRS adoption?
  - Were there differences across firms depending on information environment?

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#3 IFRS adoption in Europe

- Research design
  - All European firms
  - Market reaction to 16 events between 2002 and 2005; 13 increased likelihood, 3 decreased likelihood
  - Differences for firms with different pre-adoption information environment, banks, information asymmetry, enforcement and implementation

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#3 IFRS adoption in Europe

- Findings
  - Significant positive overall reaction to events increasing likelihood of adoption
  - Incrementally positive for firms with
    - Lower quality pre-adoption information environments, which is more pronounced for banks
    - Higher pre-adoption information asymmetry
  - Incrementally negative for firms in code law countries
  - Positive reaction for high info quality firms

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#3 IFRS adoption in Europe

- Interpretation

  => Investors perceive net benefits to IFRS adoption in Europe

  => Investors concerned about enforcement

  => Net benefits associated with perceived increased information quality and convergence

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Research example #4

Are International Accounting Standards-based and US GAAP-based Accounting Amounts Comparable?

M.E. Barth, W.R. Landsman, M. Lang, and C. Williams
Working paper 2010

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#4 Comparability of IFRS and US GAAP reporting

- Motivating questions
  - Is comparability between IFRS and US GAAP reporting higher after IFRS firms adopt IFRS?
  - Does comparability differ across firms or time?
- Research questions
  - Are accounting system and value relevance comparability higher after IFRS firms adopt IFRS?
  - Do the metrics reveal differences in comparability for voluntary versus mandatory IFRS adopters, for years before versus after 2005, and for firms from countries with code versus common legal origins?

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#4 Comparability of IFRS and US GAAP reporting

- Research design
  - Matched sample of firms adopting IFRS between 1995 and 2006 and US firms
  - Accounting system comparability
    - Difference between predicted stock prices (stock returns) resulting from applying US GAAP and IFRS pricing multiples to each firm's earnings and equity book value (earnings and change in earnings)
  - Value relevance comparability
    - Difference between explanatory powers of earnings and equity book value (earnings and change in earnings) for price (return)

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#4 Comparability of IFRS and US GAAP reporting

- Findings
  - Both types of comparability with US GAAP are higher after IFRS firms adopt IFRS
  - Both types of comparability are higher for IFRS
    - firms that adopted IFRS mandatorily
    - firm-year observations after 2005
    - firms from common law legal origin countries
  - US firms have higher value relevance but, IFRS amounts are comparable to US GAAP amounts based on value relevance for mandatory IFRS adopters and firms from common law countries

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#4 Comparability of IFRS and US GAAP reporting

- Interpretation

  => Efforts to converge accounting standards, increasing mandatory use of IFRS throughout the world, development of international auditing standards, and increasing coordination of international securities market regulators have increased comparability of accounting amounts

  => Although widespread application of IFRS has enhanced comparability with US firms, differences remain for some firms

Globalization: What does research tell us?

1. Improved disclosure and financial statement transparency can reduce cost of capital
2. Global harmonization can have beneficial capital market effects
3. Investors viewed European IFRS adoption positively
4. IFRS higher quality than non-US GAAP and not different in quality from US GAAP in many countries

Globalization: What does research tell us?

5. Comparability with US GAAP is greater than with non-US domestic GAAP, and in recent years
6. Standards are necessary, but not sufficient
7. Quality depends on incentives of managers and auditors
8. Cultures change slowly, not by fiat
9. Similar environments can be in different financial reporting equilibria – can change to be the same equilibrium with relatively small shock

Globalization: Questions for research

- Does global reporting reduce cost of capital?
- Does it facilitate allocation of capital? Cross-border trading?
- Does it reduce home bias in investing?
- Which impediments are most important?
- Does IFRS application result in higher quality financial reporting?
- What are the costs and benefits?
- What are the implications of political and regulatory pressures?

Concluding remarks

- Many open questions
- Many possible research designs
- Key is to craft a design that links the research question to the motivating question
- Contribute to both academic research and to standard setting issues
- Standard setters need input from academic research to help resolve the many issues they face
- Research has a central role to play in shaping global financial reporting!

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Thank you!

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