Why We Do International Accounting Research

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Ray Ball
Outline

- Why we do accounting research

- Why we do international accounting research:
  - To better understand others.
  - In the process, to better understand ourselves.
  - To provide more replication options.
  - To exploit national differences in institutional structure to:
    - Better understand the determinants and effects of national differences
    - Better understand universal issues in accounting
    - Address some difficulties/limitations of within-jurisdiction research
  - To obtain a wider range of changes to exploit.
  - Paradigm example: Changing to IFRS.

- Conclusions
Why we do accounting research

- Financial reporting is a large and important industry.
  - Different than (say) telecommunications, health care or consulting, but an industry nevertheless

- We study and learn about both sides of the market.
  - Supply: understanding what accountants are good at:
    -- developing methods (standards) to measure transactions
    -- independence
  - Demand: understanding what users do with accounting information:
    -- shareholders, analysts, lenders, rating agencies, boards, managers, employees, unions, press

- … and we study and learn about how supply and demand effects intersect to generate accounting information.

- Financial reporting research also has to address a substantial political/regulatory overlay.

- Overall, this is a rich but complex tapestry to study.

- International accounting research plays a special role in this process.
Early reasons for doing *international* accounting research

- We increase our understanding of (and empathy for) other countries and their institutional structures: economic, political, legal, social, etc.
  - Much of the early literature seems to have had this objective.
  - Much consisted of cataloging national differences.
  - Some effects of national differences were described, with largely small-sample correlations.
  - There was little testing of universal theories that could be refuted in multiple contexts.
  - This literature emerged before the internet and low-cost communication and travel.

- Understanding others remains an important reason for conducting *international* accounting research.
Early reasons for doing international accounting research

- We also learn about our own-country accounting, by comparing it with other countries:
  - Observing the counter-factual
  - Similar to comparing public and private firm financial reporting to better understand the implications of being “public.”
  - Observation of other countries’ systems possibly was an initial impetus to the development of IAS (subsequently, IFRS)?
- We also can discover the universal principles underlying all financial reporting by analyzing international data.
Another reason for doing international accounting research: Replication

- “Replication—The confirmation of results and conclusions from one study obtained independently in another—is considered the scientific gold standard.” Jasny et al. (2011, p. 1225)

- Replicability is an especially serious dimension of modern research (e.g., Renfro (2011). The potential for spurious results has increased due to:
  - Larger sample sizes, hence large t-stats
  - Little attention to magnitudes versus t-stats
  - Elaborate data bases give greater selection of dependent and independent variables
  - Statistical programs provide multiple model specification options
  - Cheap computing permits multiple combinations of data handling (e.g., trimming) and model choices
  - “Torturing the data until it confesses”

- Yet “. . . replicable economic research is the exception and not the rule.” Anderson et al. (2008, p.100).

- International replication plays a role in replication.
“In what appears to be a move by the [economics] profession to remedy this gross deficiency, many of the top traditional journals have recently adopted mandatory data+code archives as a means of ensuring that published results are replicable.” McCullough (2009, p.117).

“What is surprising is that the OA [open access] journals, to date, are still solidly in the market for irreproducible results. In fact, the top traditional journals are far ahead of OA journals in this regard, which is paradoxical.” (pp.117-118).

This is neither surprising nor paradoxical: the top journals have the more valuable brand to defend.

The top accounting journals now are taking action too.
Replication Options

- **Within-jurisdiction replication options:**
  - Mimic the research design exactly (same data sources, data selection, models tested, data analysis).
  - Check sensitivity to sample selection (different data sources, time periods, firms, data trimming, etc).
  - Check sensitivity to different model specifications, estimation procedures (standard errors, outliers, etc).

- **Some results replicate reasonably well across jurisdictions:**
  - Presumably because they are not substantially affected by across-regime variance in institutional factors.
  - e.g., Ball and Brown (1968) event study graph, Sloan (1996) accruals anomaly.

- **Other results replicate as a function of institutional variables that matter according to the underlying theory:**
  - Thereby confirming the theory
  - e.g., Basu (1997) asymmetry as a function of legal & economic systems

- **Replication is a reason for international accounting research.**
Reasons for doing international accounting research:
Lack of variance in within-regime studies

- Firms within a given regime face a relatively homogeneous environment:
  - economic, legal and political systems
  - accounting rules
  - regulatory & litigation incentives.

- Implication: The major influences on financial reporting practice are expected to occur at the regime level.

- Example: Exploiting variation in debt market size.
  - Financial reporting (i.e., supply) is a costly activity, so the resources put into it will/should reflect demand.
  - High-debt regimes (with larger, better developed debt markets) have greater demand for high reporting quality.
  - But both low-debt and high-debt firms in a high-quality regime are held to a standard of high reporting quality.

- Many universal influences on financial reporting practice are better identified in cross-regime studies.
International designs have more institutional complexity to exploit

- Accounting research maps into data whose domain is “institutional.”
  - e.g., The conceptual economic signal $X$, versus the institutional variable “Income From Discontinued Operations” under GAAP.

- Accounting research isn’t simply lower-quality economics, sociology, psychology, finance, etc.

- Some implications:
  - The institutional shape of the data necessitates a poorer fit between data & theory than is accepted in basic disciplines.
  - There are different research design trade-offs in accounting than in the basic disciplines (Ball and Foster JAR Supplement 1982).
  - This makes accounting research especially challenging.
  - Detailed, subtle knowledge of institutional facts is our (eroding?) source of comparative advantage.

- The additional institutional complexity in international research provides both opportunities and difficulties for accounting research.
Aside comment: Beware intellectual arbitrage

- Accounting researchers historically have a comparative advantage in:
  - knowing the institutional variables; and
  - addressing the imperfect fit between data and theory.
- The increased range of topics and research designs in accounting is largely due to borrowing from other areas: Finance, economics, sociology, anthropology.
- But arbitrage goes both ways.
  - Scholars in other areas have been moving into topics traditionally occupied by “accounting” people.
  - Increasingly, accounting researchers have limited knowledge of institutional facts.
- Implication: Increased importance of knowing the literature and research designs in relevant adjacent areas.
Cross-regime variance in demand for financial reporting

- There are firm-level costs of developing & operating:
  - Financial information collection and reporting systems
  - Internal control
  - Internal audit
  - External audit
  - Management & boards

- And there are substantial country-level costs of developing & operating an effective reporting infrastructure, including:
  - Securities laws
  - Accounting rules
  - Independent, effective judiciary
  - Independent, effective audit profession
  - Education
  - Effective regulatory function
  - Monitoring institutions (analysts, rating agencies, press, etc.)

- Larger, more-developed, richer economies build high-quality financial reporting infrastructure.

- Smaller, less-developed, poorer countries cannot be expected to have made the same level of investment in financial reporting infrastructure.

- The resources devoted to financial reporting will/should reflect demand.
Aside comment: Accounting quality is costly

- Financial reporting cost most likely is an increasing function of financial reporting quality:
  - **Cash.** Even counting and verifying cash flows and balances accurately is costly. Exemplified by:
    - Parmalat (faked sales, cash collections and cash balances)
    - Enron (fabricated fraudulent transactions to affect the classification of cash flows as operating versus financing)
  - **Accruals.** The cost of making accruals in general increases in how comprehensive, accurate, and free of management manipulation they are.
  - **Fair value gains and losses** (including impairment charges). These are a particularly costly reporting activity because they involve longer-run cash projections.

- The resources devoted to financial reporting will/should reflect demand.
- Demand is an increasing function of market development (more over).
Aside comment: On testing institutional complementarity

- Causality can be difficult to determine since supply and demand normally vary at the same time.

- However, we are not always interested in causality.

- Institutions are complements.
  - Interesting hypothesis: Countries with deeper public capital markets have higher-quality public reporting.
  - Conversely, countries where more economic activity is undertaken in private companies, or that communicate information more through insider networks, have lower-quality public reporting.

- What comes first? Deep public markets or higher quality reporting?
- Does it matter for purposes of testing this hypothesis?

- Sometimes we are only interested in researching a complementarity.
  - Testing consistency, not causality
  - Being careful not to over-control: some correlated omitted variables are what we exploit.
Wider range of institutional change to exploit; The case of IFRS

- IFRS adoption provides a rare “experiment” with:
  - A very substantial change in financial reporting
  - In many countries
  - For a large number of firms

- Finding reliable, substantial effects is difficult, however.
  - We have only 9-10 years of post-IFRS data
  - At least 5 are affected by the GFC and subsequent malaise
  - Confounding events
  - Effects might be relatively small.
  - Are long run elasticities larger or smaller?

- Commentators reading teacups see IFRS benefits such as reduced COC:
  - The ”market for excuses” at work?

- Nevertheless, IFRS implementation provides a rare opportunity to research important issues.
Example: Changes in rules and enforcement

- The importance of incentives has been known for some time.
  - Enforcement constitutes a subset of incentives
  - Enforcement by regulators is a subset of enforcement generally (e.g., by internal and external auditors, boards, analysts, whistle-blowers, press).

- IFRS (and IAS) adoption allows us to study the relative effects of changes in rules and in enforcement.

- The emerging consensus is that changes in rules have little effect without effective enforcement or other incentives.*

- The result occurs in different contexts, including private versus public companies, and thus seems universal.

- i.e., the result replicates.

* Ball et al., 2000, 2003; Daske et al., 2008; Christensen et al., 2013a; Daske et al., 2013; Cascino and Gassen, 2014
Example: IFRS introduction and debt contracting

- IFRS introduction is generally believed to increase transparency:
  - Higher quality standards
  - Increased use of fair-value accounting
  - Increased disclosure

- Does that make financial statement information more useful in all contexts?

- Special problems arise from a debt contracting perspective:
  1. IFRS provide managers more choice among methods
  2. IFRS provide managers with more discretion in implementation
  3. Subjectivity of many FV estimates impairs contractibility
  4. Frequent IFRS changes make contractual rights uncertain
     - Temporary around 2005, or a long run structural IASB problem?
  5. Fair value earnings incorporate transitory shocks to asset values
  6. FV changes due to shocks to expected returns (i.e., discount rates) rather than to cash flows reverse in part or full before debt maturity
  7. Lenders want to monitor the amount of the borrower’s contractual obligation to repay its debts, not its fair value

- A unique setting to contrast contracting and valuation demand.
Possible responses from lenders and borrowers

- Debt contracts can be amended to ameliorate problems.
- This is costly, perhaps impossible in some cases.
  - Some earnings and balance sheet components can be excluded from contractual definitions, but audited financial statements do not always provide sufficient information to do so.
  - “Frozen GAAP” requires keeping multiple sets of audited accounts.
- Proposition: For some firms, the more efficient response is to:
  - Reduce the use of accounting-based covenants -- e.g., leverage, interest coverage
  - Substitute non-accounting covenants -- e.g., investment restrictions, asset sale restrictions, equity issue restrictions, and debt issue restrictions
- What is the evidence?
No. of issuances with accounting covenants

- We can test this proposition in a diff-in-diff design*
- 2001-2010 (spans IFRS adoption)
- Sample: 3037 new debt issuances:
  - 1362 in 22 IFRS countries (treatment sample)
  - 1675 in 21 non-IFRS countries (control sample)

* Ball, Li and Shivakumar (2015).
This type of evidence would not have been available in a single-regime research design.

For example, under the convergence project, the US adopted most of the same rules as IFRS, but gradually over time and hence difficult to identify effects.

Widespread IFRS adoption in 2015 provides a rare “big bang.”
Conclusions

Why do we do it?

- Because accounting is an important industry everywhere.
- To better understand others.
- In the process, to better understand ourselves.
- To replicate results in other contexts (with predicted changes).
- To exploit international *differences* in institutional structure to:
  - Better understand the determinants and effects of national differences in accounting;
  - Better understand universal issues in accounting; and
  - Address some difficulties/limitations of within-jurisdiction research.
- To obtain a wider range of institutional *changes* to exploit.
- We live at a high point in international accounting research.
- Thank you, and enjoy the conference.
References


