

PhD Seminar: Empirical Research in Accounting for Financial Markets February-March 2019

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1. Course Objectives

The main aims of this seminar is to study a selection of significant and emerging research themes in the empirical financial accounting research literature. The focus is on research that leads to better understanding of the behavior of international financial markets and of the roles of financial reporting, governance, regulation and enforcement in determining market outcomes. We will consider the historical origins, theoretical basis and research methods of selected key papers drawn from the literature. We will also reflect on how successful academic papers are structured and crafted. An important objective is to develop understanding of some the key elements in developing and writing successful research papers. We will also allow time for discussion of opportunities that exist for new research capable of having academic, and perhaps broader, impact.

2. Reading

The course outline below identifies some key papers that we will discuss in seminar sessions. There are two types of reading assignment: background papers (mainly literature reviews) and recent empirical papers (marked with an asterisk *). Details of further relevant references will be provided during seminars. Please note that these papers do not represent a comprehensive bibliography in any area. Rather they are intended as a starting point for those wishing to study a topic.

Papers should be available online via the Bocconi Library electronic resources and where copyright allows will be made available via the virtual learning environment. Please let me know if you have any difficulties in tracing specific references.

You are expected to have read and thought critically about the assigned empirical papers marked * papers *before* each session. You should take the opportunity during seminar sessions to raise any questions you have as a result of your reading.

3. Assessment

	%
Class preparation, participation and paper discussions	40

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Research proposal/pilot study	<u>60</u>
Total	<u>100</u>

4. Format of Sessions

Sessions will be conducted using a workshop format. Therefore, students are expected to have read beforehand the assigned reading and be ready to discuss them during class. In general, the class discussions will be based around a review paper(s) and two selected papers each session (Primary reading). Suggested additional reading will be referenced during class.

Typical class sessions will start with an introduction to the topic, including discussion of the review paper (max. 30 minutes). Then we will discuss the other assigned papers, based on presentations led by students, with an expectation that all of us will participate.

5. Presentations

Discussions of papers will start with “Libby Boxes” diagrams. At the beginning of each session, all students should turn in copies of their Libby boxes for the assigned papers. They will form part of the class participation grade. Please see the Appendix for more on Libby Boxes.

In studying and discussing the papers you are asked to identify the theoretical and empirical constructs for each of the Libby boxes and provide the justification used by the authors of the assigned paper for each of the 5 links in the Libby boxes’ diagram. For example, how do the authors justify their operationalisation of the conceptual explanatory variable (link 2)? In the next step, you should provide a critical assessment of each of those links: Is the justification provided by the authors sensible? Are there alternative constructs that could have been used? Are there any explicit or implicit research choices made by the authors, and do those choices stand up to criticism?

See the Appendix for a brief description of the Libby Boxes technique. A template is also attached at the end of this outline.

Note: The structure of sessions may be subject to change. Changes, if any, will be communicated in class.

6. Research proposal

In the final two sessions of the course you will be asked to present your own research proposals for an empirical study relevant to financial reporting and capital markets. The research you present could be part of your thesis proposal (if you are planning to develop a research specialism in accounting) or another idea that in due course could lead to a working paper, perhaps in collaboration with a colleague or faculty member. Either way your ideas should be sufficiently well-developed for feedback to be useful. That feedback will come from me and from the other course participants.

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You are expected to come to the designated session in the final two weeks of the course prepared to present your research as well as to engage actively in constructive discussion relating to the research of other students.

You will have approximately 20 minutes to present your research, including time for interactive discussion. Thus, you will need to manage the timing of your presentation as it progresses. We will adhere strictly to the time limits, so plan accordingly. Once we know exactly how many students have enrolled in the sessions, we can be more precise and let you know which day and time you will present. If we need to find an extra meeting time, we will do so.

To provide background for your presentation, please submit by xxxx the following documentation. This will be distributed to the other participants to enable them to come to the sessions prepared to provide comments and suggestions on your research.

- (a) A clear and concise statement providing answers to the following three questions, namely:
 - i. What is the question(s) you are trying to answer?
 - ii. Why is the question(s) important?
 - iii. How are you going to design the study to address it (them)?

Note that the research question should be written as a question, that is, it should end in a “?” It is best if you answer each of these questions in a single paragraph. Some refer to this approach as the “Kinney 3-paragraph approach,” which has proven effective in helping to develop research papers. This approach is systematic and integrated: each of the three elements above must be consistent with the other two and with the title of the paper. Important: Try to do this write-up in one page, and under no circumstance should you exceed two pages (12 point font, one inch margins!). The challenge is to be clear and concise. For projects that propose analysis of data (e.g., empirical/archival, experimental, survey), a depiction of “Libby boxes” that relate the theoretical constructs to independent variables, dependent variables, and control variables is often an effective way to give an overview of the research design. See the Appendix.

- (b) A Synopsis of a maximum of 150 words that assumes the study’s results turn out as you expect.

You will be asked to READ aloud your Synopsis to start your presentation. Important: Build your Synopsis from the Kinney 3 paragraphs, including one sentence that captures the main point of each paragraph.

- (c) A Presentation

Please arrive at the session with a thumb drive that contains the file with any slides that you will use in your presentation. An effective set of slides would include one slide for the Synopsis, one slide for each of the three Kinney paragraphs, and one slide for the research design overview, including the Libby boxes if you choose to use them. You can include additional slides, e.g., showing sample potential properties or preliminary results if data has already been gathered, if you have other aspects of the research you believe it is important to present, but be mindful of the time limit. As indicated above, all

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participants will have read the short write-up you provide in advance, so plan on more of a discussion than a presentation.

7. Course Outline

Session 1: Identification and endogeneity in accounting research

- What is the problem?
 - Why do we care to draw causal inferences?
 - Remedies and research design strategies to address endogeneity and to get identification
1. Rabin, Alcohol's Good for You? Some Scientists Doubt It, *New York Times*, 16 June 2009.
 2. Leuz, C. and P. Wysocki, 2016, The Economics of Disclosure and Financial Reporting Regulation: U.S. and International Evidence and Suggestions for Future Research, with Peter Wysocki, *Journal of Accounting Research*. (Sections 1 and 2)
 3. Gow, I., D. Larcker, and Reiss, 2016, Causal Inference in Accounting Research, *Journal of Accounting Research*. (Sections 1-3 and skim Section 5)

Session 2: Early capital markets research

- Who we are
 - Seminar objectives
 - Empirical financial accounting research: an historical perspective
 - Accounting-based valuation theory: a thumbnail sketch
1. Ball, R. and P. Brown. 2014. Ball and Brown (1968): A retrospective. *The Accounting Review* 89 (1): 1-26.
 2. Kothari, S. P. 2001. Capital markets research in accounting. *Journal of Accounting and Economics* 31 (1-3): 105-231 (Note: pp. 105-160 only for this session).
 3. *Daniel W. Collins, Edward L. Maydew, Ira S. Weiss. 1997. Changes in the value-relevance of earnings and book values over the past forty years. *Journal of Accounting and Economics* 24 (1), 39-67.
 4. *Landsman, W., K.V. Peasnell, P. Pope, and S. Yeh. 2006. Which Approach to Accounting for Employee Stock Options Best Reflects Market Pricing? *Review of Accounting Studies*, 2006.

Session 3: Market-based assessment of accounting disclosure & recognition

- Methodological foundations for market-based tests in accounting research

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- Implications for empirical research on: corporate disclosure, recognition policies, corporate transparency
 - Prices leading accounting numbers – implications for research design
 - Contemporaneous association between prices/returns and accounting numbers - causation
 - Accounting numbers leading future returns and implications for market inefficiency
 - Common errors-in-variables problems in capital markets studies
 - Instrumental variables and other solutions
1. Collins, D., Kothari, S., Shanken, J., and Sloan, R., 1994. Lack of timeliness and noise as explanations for the low contemporaneous return-earnings relation. *Journal of Accounting and Economics* 18, 241-276. (Read Sections 1 and 2)
 2. *Guest, Nicholas M. and Kothari, S.P. and So, Eric C., Flight-To-Dividends: The Role of Earnings in Periods of Capital Scarcity (November 28, 2017). Available at <https://ssrn.com/abstract=2929704>.
 3. *Ferri, Fabrizio and Zheng, Ronghuo and Zou, Yuan, Uncertainty in Managers' Reporting Objectives and Investors' Response to Earnings Reports: Evidence from the 2006 Executive Compensation Disclosures (October 1, 2017). Columbia Business School Research Paper No. 17-14; Available at SSRN: <https://ssrn.com/abstract=2902246> or <http://dx.doi.org/10.2139/ssrn.2902246>

Session 4: Effects of Accounting Standards and IFRS adoption

- Identification of IFRS and standard effects
 - Market outcomes and their relevance
 - Alternative explanations and confounding effects
 - Comparability effects
 - Label adoption
 - Role of enforcement
1. Leuz, C. and P. Wysocki, 2016, The Economics of Disclosure and Financial Reporting Regulation: U.S. and International Evidence and Suggestions for Future Research, with Peter Wysocki, *Journal of Accounting Research*. (Section 5)
 2. *Armstrong, C. S., M. E. Barth, A. D. Jagolinzer and E. J. Riedl, 2010. Market reaction to the adoption of IFRS in Europe. *The Accounting Review* 85 (1): 31-61
 3. *Christensen, Hail, and Leuz, 2013, Mandatory IFRS Reporting and Changes in Enforcement, *Journal of Accounting and Economics* 56, 147-177.

Session 5: Disclosure Regulation

- Why mandate disclosure? Rationales for mandating disclosure
 - Link between disclosure, market liquidity and the cost of capital
 - Externalities and information spillovers
 - What have we learned from regulatory studies?
 - Challenges of regulatory studies
1. Leuz, 2010, Different Approaches to Corporate Reporting Regulation: How Jurisdictions Differ and Why, *Accounting and Business Research* 40, 229–256. (Read Section 2 only)
 2. Leuz, C. and P. Wysocki, 2016. The Economics of Disclosure and Financial Reporting Regulation: U.S. and International Evidence and Suggestions for Future Research, with Peter Wysocki, *Journal of Accounting Research*. (Sections 2.2, 4.1 and 4.2)
 3. *Christensen, Hail, and Leuz, 2016. Capital-Market Effects of Securities Regulation: Prior Conditions, Implementation and Enforcement, *Review of Financial Studies*, 2016.
 4. *Iliev, 2009. The Effect of SOX Section 404: Costs, Earnings, Quality, and Stock Prices, *Journal of Finance* 65, 1163-1196. (Just focus on the identification strategy)

Session 6: Attributes of financial reporting for capital markets and policy

- Theoretical foundations and financial reporting attributes
 - Financial reporting quality metrics
 - Limitations of accruals models
 - The roles of innate factors
 - The roles of accounting standards
 - Institutional determinants
 - Measuring institutional strength and accounting distance
 - International differences in financial reporting quality
 - The roles of auditors and governance
 - Monitoring by analysts
1. Dechow, P., W. Ge and C. Schrand, 2010. Understanding earnings quality: A review of the proxies, their determinants and their consequences. *Journal of Accounting and Economics* 50, 344–401. (Read Section 3.1.1 – pages 350-358 including Exhibit 1).
 2. Leuz, C., 2010. Different Approaches to Corporate Reporting Regulation: How Jurisdictions Differ and Why. *Accounting and Business Research* 40, 229–256. (Read Sections 3 and 4).

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3. Leuz and Wysocki, 2016. The Economics of Disclosure and Financial Reporting Regulation: U.S. and International Evidence and Suggestions for Future Research, with Peter Wysocki, *Journal of Accounting Research*. (Sections 4.3 and 5.1)
4. *Dechow P., and I. Dichev, 2002. The quality of accruals and earnings: The role of accruals estimation errors. *The Accounting Review* 77, 35-59. (Read Section II)
5. *Burgstahler, Hail, and Leuz, 2006. The Importance of Reporting Incentives: Earnings Management in European Private and Public Firms, *The Accounting Review* 81, 983-1016.

Session 7: Fair Value Accounting

- Link between fair value accounting and capital regulation for banks
 - Role of fair value during the crisis
 - Fair valuation of assets and liabilities during the Global Financial Crisis
 - Did fair value accounting cause the financial crisis?
1. Acharya, V., and S. Ryan, 2016. Banks' Financial Reporting and Financial System Stability. *Journal of Accounting Research*, 277-340.
 2. Laux, C., and Leuz, C., 2010, Did Fair-Value Accounting Contribute to the Financial Crisis? *Journal of Economic Perspectives*, Winter, 93-118.
 3. *Ball, R., X. Li, and L. Shivakumar, 2015. Contractibility and Transparency of Financial Statement Information Prepared Under IFRS: Evidence from Debt Contracts around IFRS Adoption. *Journal of Accounting Research*, 53: 915–963.
 4. *Fontes, J.C., Panaretou, A., Peasnell, K.V., 2018. The Impact of Fair Value Measurement for Bank Assets on Information Asymmetry and the Moderating Effect of Own Credit Risk Gains and Losses, *The Accounting Review*.

Session 8: Anomalies, risk and mispricing

- Anomalies and market efficiency
 - Rational economic theory versus behavioral theory
 - Accounting numbers, GAAP, risk and expected returns
 - Unconditional accounting conservatism
1. Richardson, S., Tuna, I., Wysocki, P., 2010. Accounting anomalies and fundamental analysis: A review of recent research advances. *Journal of Accounting and Economics* 50, 410–454. (Read sections 4 and 6)
 2. Penman, Stephen H., and Julie Lei Zhu. "Accounting anomalies, risk, and return." *The Accounting Review* 89, no. 5 (2014): 1835-1866. (Read sections II-IV)
 3. *Lyle, Matthew R., Jeffrey L. Callen, and Robert J. Elliott. "Dynamic risk, accounting-based valuation and firm fundamentals." *Review of Accounting Studies* 18, no. 4 (2013): 899-929. (Read sections 3 and 4)

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4. *Green, J., J. R. Hand, and X. F. Zhang, 2017. The characteristics that provide independent information about average us monthly stock returns. *The Review of Financial Studies*, 30(12), 4389-4436.

Session 9: Conservatism and investor information needs

- Equity investors and creditors: do their information needs differ
 - Endogenous financial contracting and corporate financial policy
 - Conditional conservatism: asymmetric persistence, asymmetric timeliness
 - Unconditional conservatism
 - Debt contracting and accounting conservatism
1. Basu, S. 1997. The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics* 24: 3–37.
 2. Pope, P. F., and M. Walker, 1999. International differences in the timeliness, conservatism and classification of earnings. *Journal of Accounting Research*, Supplement 53-98. (Read pages 58-64).
 3. *Collins, D., P. Hribar and X. Tian, 2014. Cash flow asymmetry: Causes and implications for conditional, *Journal of Accounting and Economics* 2014.
 4. *Nikolaev, V. 2010. Debt covenants and accounting conservatism. *Journal of Accounting Research* 48(1): 51-89.

Session 10: Fraud, Scandals and Accounting

- Corporate scandals
 - GAAP violations and misleading disclosure
 - Predicting and detecting misstatements
 - Financial reporting enforcement mechanisms
 - Governance and audit
 - The role of incentives and accounting competence
 - Registered research reports and data mining
1. Amiram, D., Z. Bozanic, J.D. Cox, Q. Dupont, J.M. Karpoff and R. Sloan, 2018. Financial reporting fraud and other forms of misconduct: a multidisciplinary review of the literature. *Review of Accounting Studies*.
 2. Bloomfield, R.J., K.M. Rennekamp and B. A. Steenhoven, 2018. No System is Perfect: Understanding How Registration-Based Editorial Processes Affect Reproducibility and Investment in Research Quality.
<https://ssrn.com/abstract=3118687> or <http://dx.doi.org/10.2139/ssrn.3118687>
 3. *Hoberg, G. and C. Lewis, 2017. Do fraudulent firms produce abnormal disclosure? *Journal of Corporate Finance*, 43, 58-85.

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4. *Hail, L., A. Tahoun, and C. Wang, 2018. Corporate Scandals and Regulation. *Journal of Accounting Research*.

Session 11: Student presentations

Session 12: Student presentations

Appendix: Libby Boxes

Extract from

Bloomfield, R. J. (2015). Rethinking managerial reporting. *Journal of Management Accounting Research*, 27(1), 139-150.

What Gets Counted is not the Same as What Counts

The most important lesson in managerial reporting is that we must distinguish between what counts and what gets counted. To an investor, increasing owners' wealth through business operations counts; net income is what gets counted. To a product manager, customer satisfaction counts; the score on a two-question survey is what gets counted. To a teacher, learning is what counts; exams scores are what get counted.

The distinction between what counts and what gets counted is as old as Plato's "Allegory of the Cave," which argued that our perceptions show us merely the shadows of underlying reality. Social scientists have refined this distinction through the predictive validity framework, best known to many accounting faculty through its visual representation in "Libby Boxes" (Libby 1981).

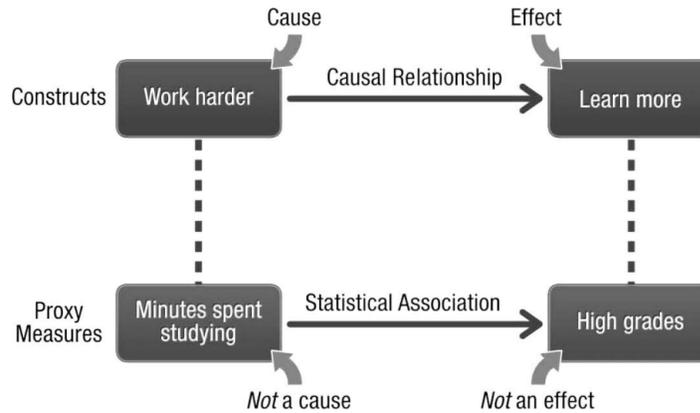
Figure 1 shows how Libby Boxes can be used to represent what counts and what gets counted. The top boxes are the underlying constructs that theory posits have a cause-and-effect relationship: hard work causes more learning. This is what counts. The bottom boxes are the proxy measures for each construct. We measure hard work by time spent studying, and we measure the amount learned by exam score. This is what gets counted. Because other factors are likely to affect both learning and exam scores, Figure 2 includes a fifth box to capture variables that we have omitted from our simple model, even though they may influence what gets counted as an effect (grades). Omitted variables might influence the amount actually learned (e.g., more intelligent people learn more), or might simply influence measurement error (e.g., stress biases test scores downward, so grades are lower even though learning is unchanged).

The Libby Box framework, a staple of doctoral education in accounting, is an exceptionally useful tool for anyone who wishes to understand managerial reporting:

- The causal links between constructs reflect a strategy, as defined by Kaplan and Norton (1996): "a hypothesis of cause-and-effect relationships." As discussed above, this strategy is most likely taken from courses outside of managerial reporting, such as marketing, economics, finance, or



FIGURE 1
Using Libby Boxes to Represent Causal Constructs and Their Proxy Measures



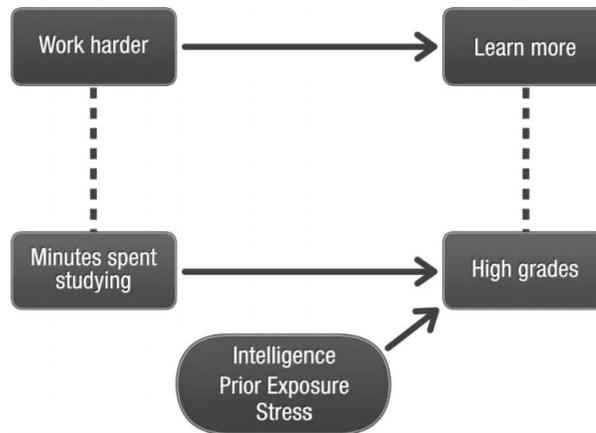
The top boxes indicate constructs that are causally related. The bottom boxes indicate proxy measures for each construct, which are merely statistically related. The dashed vertical lines indicate measurement error separating each construct from its related proxy measure.

The original color version of Figure 1 is available for download, see Appendix A.

operations. In the Balanced Scorecard, objectives are constructs, while measures are operational rules for constructing observable proxy measures that attempt to capture those constructs.

- Proxy measures almost always suffer from measurement error, such as bias or noise. Note, also, that while constructs have a causal relationship, the measures usually have only a

FIGURE 2
Libby Boxes with Omitted Variables



As in Figure 1, the top boxes indicate constructs that are causally related. The bottom boxes indicate proxy measures for each construct, which are merely statistically related. The oval at the bottom indicates omitted variables that can affect the proxy measure for the effect, either by altering the construct of the effect through a cause other than the one hypothesized, or by altering the measurement error between that construct and its proxy.

The original color version of Figure 2 is available for download, see Appendix A.