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Research, Standard Setting, and Global Financial Reporting

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Abstract

The objective of this paper is to aid researchers in conducting research relevant to global financial reporting issues, particularly those of interest to financial reporting standard setters. The mission of the International Accounting Standards Board (IASB) is to develop a single set of financial reporting standards that are accepted worldwide. The Financial Accounting Standards Board (FASB) is committed to convergence of its standards with those of the IASB. Thus, global financial reporting issues relate to particular topics on the agendas of the IASB and the FASB. They also relate to globalization of financial reporting itself. This paper discusses research related to both types of issues and explains how that research can aid standard setters in resolving global financial reporting issues as well as contribute to the academic literature. The issues facing global financial reporting standard setters are broad, difficult, and complex. Research can provide input to their resolution. To do so, researchers need to understand not only the issues themselves, but also how to develop research questions and designs that are relevant to the issues, from the perspective of both standard setting and the academic literature.

Contents

1

Introduction

The objective of this paper is to aid researchers in conducting research relevant to global financial reporting issues, particularly those of interest to financial reporting standard setters. The mission of the International Accounting Standards Board (IASB) is to develop a single set of financial reporting standards that are accepted worldwide. The Financial Accounting Standards Board (FASB) is committed to convergence of its standards with those of the IASB. Thus, global financial reporting issues relate to particular topics on the agendas of the IASB and the FASB. They also relate to globalization of financial reporting itself. This paper discusses research related to both types of issues and explains how that research can aid standard setters in resolving global financial reporting issues as well as contribute to the academic literature. The issues facing global financial reporting standard setters are broad, difficult, and complex. Research can provide input to their resolution. To do so, researchers need to understand not only the issues themselves, but also how to develop research questions and designs that are relevant to the issues, from the perspective of both standard setting and the academic literature.

Whether and how research can inform standard-setting issues have long been the subject of debate among academics. Some believe research cannot be relevant to standard-setting issues because accounting standards are public goods; only standard setters, as regulators, can make the necessary social welfare trade-offs. Thus, any particular research study cannot determine what the requirements of any particular standard should be. Others believe that despite standard setting's regulatory role, research can provide insights into standard-setting issues by operationalizing the criteria the standard setters establish for deciding among alternatives when developing standards, such as relevance and reliability. These criteria are specified in the conceptual frameworks of the FASB and IASB, thereby eliminating the need for researchers to specify the unspecified objective function of standard setters. Standard setters are interested in research because they actively seek input from all constituents on all aspects of issues they consider. Research can be particularly helpful to standard setters because it is unbiased, rigorously crafted, and grounded in economic theory.[1]

Conducting research relevant to standard-setting issues requires specifying the standard-setting questions that motivate the research. Research cannot directly answer these motivating questions; most motivating questions remain unanswered for many years, and may never be resolved fully. Rather, research aids in identifying issues, helping standard-setters structure their thinking about a particular issue, and providing evidence that informs the debate about an issue. Thus, although the link between research and standard-setting issues exists, it is indirect. The key to designing and interpreting research relevant to standard-setting issues is to identify and clearly specify the link between the question motivating the research and the research question that the research can address. In making this link, researchers need to be explicit about which standard-setting criteria the research design operationalizes and how it does so. Without specifying this link,

[1] These issues are not unique to accounting; the same issues apply to the ability to link academic research to policy decisions in other fields, such as finance and economics. Also, research relating to standard-setting issues also can be of interest to preparers and users of financial statements. However, this paper focuses on how research can relate to global financial reporting standard-setting issues.

the study might be able to contribute to the academic literature, but it is less likely to contribute to understanding standard-setting issues.[2] Researchers are trained in developing research questions that contribute to the academic literature. Typically, they are not trained to develop research questions from questions motivated by standard-setting issues. Developing research questions from motivating questions is not a trivial task, but is crucial in designing research that contributes to the academic literature and also provides insights relevant to standard-setting issues.

Designing research relevant to standard-setting issues requires taking into consideration the different perspectives of researchers and standard setters. Standard setters seek to implement their conceptual frameworks to determine the form and content of financial statements. Researchers, too, are interested in these issues, but researchers are not as focused on these issues as are standard setters. Rather, researchers often focus on the role of accounting as information, the effects of incentives and discretion on accounting amounts and reporting behavior, and how accounting fits into the firm's overall information environment, which encompasses much more than financial statements. Standard setters, too, are interested in these issues, but perhaps not as much as researchers.

Financial reporting research, particularly capital markets research, is often described as adopting an information perspective or a measurement perspective. Both perspectives are consistent with the conceptual frameworks of the FASB and IASB, and they are not necessarily mutually exclusive. Regarding the information perspective, the frameworks state that the objective of financial reporting is to provide information useful to financial statement users in making economic decisions. However, the information perspective adopted by research often goes

[2] Many research studies inform standard-setting issues without specifying a motivating question. These studies do not specify a motivating question because informing standard-setting issues is not an objective of the studies. For example, findings relating to accruals versus cash flows, the role of analysts, and the market reaction to earnings announcements all reveal inferences about the role of accounting in capital markets, which is fundamental to global financial reporting. However, without specifying the motivating question, the relation to standard-setting issues is likely to be more indirect, less tightly linked to the research design, and not as readily discernable.

beyond information in financial statements. Because financial statements are the part of financial reporting that currently is under the purview of accounting standard setters, their interest in this non-financial statement information is indirect. Standard setters' interest primarily focuses on the role of non-financial information in affecting users' decisions and interpretation of financial statement information. Regarding the measurement perspective, the frameworks' discussions of measurement criteria are not extensive. Thus, when making measurement decisions, standard setters primarily rely on applying the qualitative characteristics of accounting information specified in the frameworks, particularly relevance and reliability. However, measurement decisions comprise the majority of standard setters' activity.

After considering the motivating question and potential differences in perspective, designing research to address standard-setting issues is not unlike designing research to address other issues. The design derives from the research question. In the case of research relevant to standard setting, the research question derives from a question motivated by a standard-setting issue. The conceptual frameworks of the FASB and IASB specify that the objective of financial reporting is to provide information to financial statement users, primarily providers of capital who are external to the firm, such as equity investors, in making economic decisions. Valuation research fits naturally to standard-setting issues because it focuses on the outcomes of investors' investment decisions. However, valuation research is only one type of research that can address standard-setting issues. Others include, among many other designs, research using other capital market metrics, prediction of bond defaults and bankruptcy, event studies, analytical models, and experiments.

The remainder of the paper is organized as follows. Section 2 describes the relation between research and standard-setting issues. It reviews the debate over whether and the extent to which research can inform standard-setting issues; explains why questions motivated by standard-setting issues need to be reframed before they become research questions, and overviews the information and measurement perspectives of financial reporting. Section 3 explains how a variety of research designs can be used to address research questions motivated by standard-setting issues, including valuation research and event studies.

Section 4 offers five studies as examples of research addressing a specific global standard-setting issue – use of fair value in measuring accounting amounts.[3] The section describes how each study relates to fair value standard-setting issues by identifying motivating questions and developing research questions that relate them, designing the research to address the research questions, and interpreting the findings in light of the questions and designs. These examples illustrate how researchers make research design choices that enable the research to be relevant to standard-setting issues as well as the academic literature. The section focuses on research related to fair value because consideration of fair value as the measurement attribute pervades the topics on the FASB's and IASB's agendas.[4] Also, use of fair value in financial reporting is controversial, which heightens standard setters' interest in research on the topic. The section then provides a broad list of motivating questions relating to fair value, which can be the basis for future research. Section 5 offers further opportunities for future research on specific standard-setting topics by providing motivating questions relating to the major topics on the agendas of the FASB and IASB. It is up to future researchers to use these motivating questions to develop research questions and research designs to generate relevant inferences.

Turning to issues related to the globalization of financial reporting, Section 6 explains how the IASB aims to achieve its mission of developing a single set of high quality accounting standards that are accepted worldwide. The section then offers three studies as examples of research

[3] These examples, and those in Section 6.2, are from my own work. This is because I feel more comfortable interpreting and explaining motivations for my own work rather than the work of others, not because this is the only or most important research addressing these issues. Also, this paper is not intended to be a complete review of all studies addressing standard-setting issues. The cited studies illustrate research questions, research designs, and insights obtained from a larger body of work.

[4] Neither the FASB Statement of Financial Accounting Concepts (SFAC) No. 5 (FASB, 1984) nor the IASB *Framework* (IASB, 2001) lists fair value as an example of a measurement attribute. However, these lists are not all-inclusive, and standards issued by the FASB and IASB since their conceptual frameworks were written and recent discussions relating to the measurement phase of the current joint conceptual framework project make clear that both boards consider fair value to be a measurement attribute.

motivated by issues associated with globalization of financial reporting to illustrate how these motivating questions can lead to research questions and designs that generate relevant inferences. Section 6 also summarizes extant evidence on the relative quality of accounting amounts across global standard-setting regimes and whether global financial reporting is achievable or even desirable. The section closes with opportunities for future research on issues related to globalization of financial reporting by identifying motivating questions that are potentially fruitful avenues for future research.

2

Research and Standard-Setting Issues

2.1 The Debate

The extent to which research can inform standard setting has been the subject of debate among academics for many years. In large part because of the development of the notion of market efficiency, in the late 1960s, capital markets research in finance and accounting became more prevalent. Accountants conducting capital markets research focused on testing the relation between accounting amounts and share prices and returns. In response to this growing trend, researchers began to study the relation between share prices, or returns, and accounting information, i.e., value-relevance research, as a way to address accounting standard-setting issues.

Gonedes and Dopuch (1974) point out that some of these early capital markets-based studies over-interpret inferences relating to standard-setting issues. Gonedes and Dopuch (1974) explain that despite market efficiency, finding a relation between accounting amounts and equity prices or returns is not sufficient to determine desirability or effects of particular standards. This conclusion reflects the fact that accounting standards essentially are a public good and, thus, standard setters develop standards after making social welfare trade-offs. In particular, some firms might enjoy net benefits from a particular standard while others bear net costs. If so, basing inferences on equity prices of either the net beneficiaries or the firms bearing net costs leads to an incomplete analysis of the standard's effects. If the standard affects benefits or costs for individuals, even analyzing equity prices for all firms is incomplete. For example, if a standard requires a firm to disclose what had been private information, it is possible for the disclosing firm to lose an informational advantage to a competitor firm and for informed investors to lose an informational advantage to uninformed investors. Thus, determining the desirability of accounting standards requires specifying social preferences, i.e., how to measure and weight the net benefits to some capital market participants and the net costs to others, which none of the accounting capital markets-based studies does.

Although Gonedes and Dopuch (1974) raised researchers' awareness of the complications involved in linking capital markets-based research to standard-setting issues, it did not end the debate. More recently, Holthausen and Watts (2001) argue that the value-relevance literature has little to say about standard-setting issues. Also, Holthausen and Watts (2001) observe a growing literature that investigates the empirical relation between stock market values, or changes in values, and particular accounting amounts for the purpose of assessing or providing a basis of assessing those amounts' use or proposed use in an accounting standard. Holthausen and Watts (2001) label as value relevance the group of papers that are at least partially motivated by the desire to provide input into standard-setting debates. The crux of the Holthausen and Watts (2001) argument is that without underlying theories that explain and predict accounting, standard setting, and valuation, value-relevance studies simply report associations. Holthausen and Watts (2001) observe that researchers' assertions that standard setters should consider a significant relation between accounting amounts and share prices, or returns, as a desirable attribute of that accounting amount are insufficient for research to claim relevance to standard-setting issues. Rather, Holthausen and Watts (2001) maintain that researchers must specify the objective of standard setting and how using the association criterion helps standard setters achieve that objective.

Barth et al. (2001) take a different view of the relevance of the value-relevance literature for standard-setting issues. In contrast to Holthausen and Watts (2001), but consistent with prior literature, Barth et al. (2001) define an accounting amount as value relevant if it has a predicted association with equity market values. Barth et al. (2001) explain that researchers need not specify a complete theory of accounting and standard setting for value-relevance research to be relevant to standard-setting issues. Rather, the FASB and IASB specify in their conceptual frameworks the objective of financial reporting and standard setting, as well as the criteria standard setters use in selecting among accounting alternatives.[1] Thus, researchers can inform standard-setting issues by using valuation models to develop research designs that operationalize these criteria.[2]

The two primary qualitative characteristics of accounting information specified in the FASB's and IASB's conceptual frameworks are relevance and reliability (Statement of Financial Accounting Concepts (SFAC) 2: FASB, 1980, IASB, 2001, IASB, 2006b).[3] Accounting infor-

[1] The FASB's conceptual framework is specified in SFAC 1 through SFAC 7 (FASB, 1978 through 2000). The IASB's conceptual framework is specified in its *Framework for the Preparation and Presentation of Financial Statements* (IASB, 2001). The two frameworks are similar, although not identical. Thus, all references in this paper to concepts in one of the two frameworks apply to concepts in the other, unless specifically noted. The FASB and IASB presently are conducting a joint project to converge, update, and complete their frameworks. See FASB/IASB (2005) for a discussion of the reasons for the conceptual framework project. As part of that project, the two boards have jointly issued a discussion paper that presents their preliminary views on the first two chapters of the joint framework – Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information (IASB, 2006b).

[2] Standard setters have in mind a policy decision-making model. Specifying that model in a general equilibrium framework that includes a social welfare function is extremely difficult, if not impossible. Instead, researchers focus on partial equilibrium models based on conditional distributions of variables, with the objective of determining whether the observed conditional distributions are consistent with those implied by the standard setters' unspecified decision-making model. That is, researchers determine whether the research findings are consistent with the criteria specified by standard setters, not the correct standard-setting decision implied by the policy decision-making model.

[3] Many believe that relevance and reliability cannot be achieved simultaneously. However, it is an open question whether this is the case and, if it is, what the trade-offs are. See Section 4.2.