McCombs Knowledge To Go



February 12, 2012



Current Financial Accounting Research



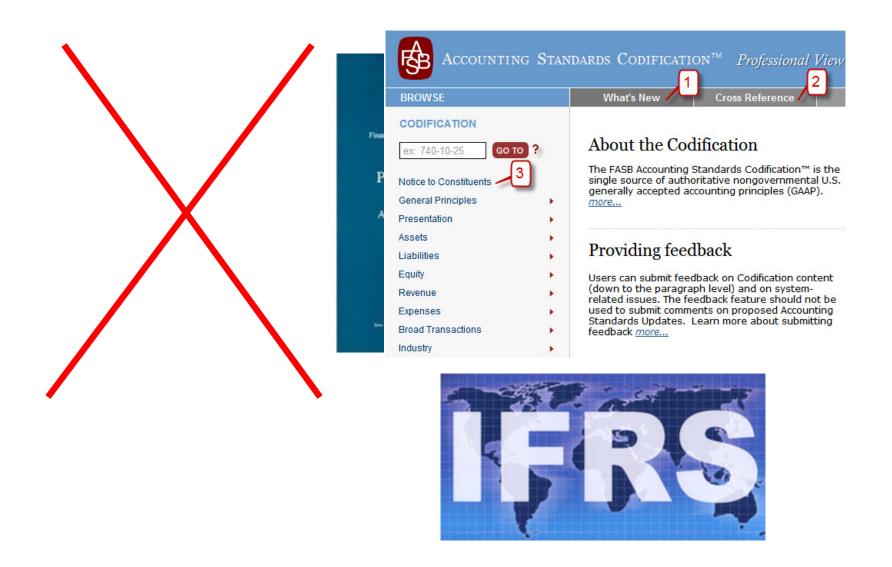
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What would you say it is that you do here?



Well, I teach financial accounting



But I also do research

Accounting and security prices

Earnings management / Accounting fraud / litigation

Current standard setting issues

Recent research you may find interesting

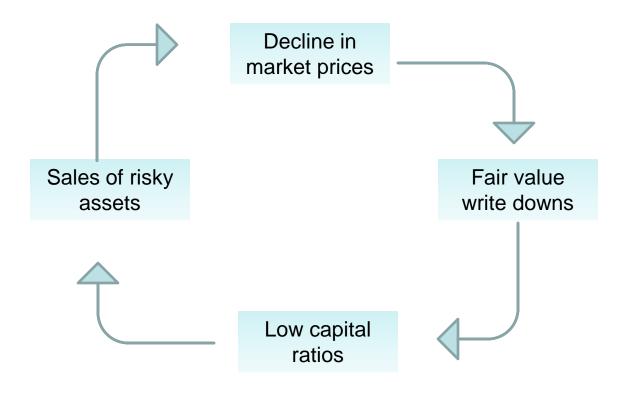
- Fair value accounting in the banking industry
 - Did fair value write downs exacerbate the financial crisis?
 - Are fair values "better" than historical costs?
- Rules-based vs principles-based accounting standards and their effect on litigation and enforcement
- Did SOX-era governance reform work in reducing accounting fraud?



Did fair value accounting contribute to the financial crisis?

- Some claim that fair value accounting exacerbated the financial crisis and led to "pro-cyclicality"
- Is this true? Is there any systematic empirical evidence on this issue?

Fair value and pro-cyclicality



Findings

Bhat, Frankel, and Martin (2011)

- Positive link between asset sales/purchases and MBS prices
- Link is attenuated after April 2009 mark to market rules

Badertscher, Burks, and Easton (2012)

- Most fair value write-downs did not affect regulatory capital
- No evidence of systematic increase in securities sales during the crisis

Takeaway

Although fair value accounting may have had some pro-cyclical effect during the crisis, it does not appear to be economically significant

Is fair value for financial instruments more useful to users than historical cost?

- Depends
- For securities, the answer appears to "yes" in most cases
 - Stock price evidence
 - Evans, Hodder, Hopkins (2011)
- What about more illiquid financial instruments, like loans?
 - Stock price evidence
 - Cantrell, McInnis, Yust (2012) [CMY]

CMY (2012)

- We investigate whether bank loans measured as fair value or net historical cost better predict future credit losses:
 - Chargeoffs
 - Non-performing loans
 - Bank failures
- Our tests indicate net historical costs generally do a better job
- Why?



Takeaway

- Net historical cost accounting for loans appears to be more useful in assessing credit risk that fair values as currently reported
- Standard setting implications

Rules vs principles-based accounting standards

- Do detailed rules-based standards increase or decrease litigation risk?
 - Donelson, McInnis, and Mergenthaler (2012)
- Examine all class action securities litigation from 1996 to 2005
- Classify standards in GAAP as more or less rules-based
 - Bright line thresholds
 - Scope or legacy exceptions
 - Excessive detail
 - Excessive implementation guidance

What we find

- In cases where firms do not admit to a mistake (no restatement), plaintiffs tend to target principles-based areas of GAAP
- In cases where firms do admit to a mistake (via a restatement), plaintiffs tend to target the principles-based restatements
- Takeaway: rules-based standards appear to decrease litigation risk

Sox-era governance reforms

- Do more independent boards and audit committees reduce the risk of accounting fraud?
- Does providing non-audit services to audit clients increase the risk of accounting fraud?
- Difficult to infer causation from crosssectional association studies



Donelson, McInnis, Mergenthaler (2012)

- In response to accounting frauds, Congress (via SOX) and the exchanges mandated increases to board independence, audit committee independence, and banned most nonaudit services to audit clients
- "Natural" experiment
- Did forcing firms to do this reduce the risk of accounting fraud?

Findings

- Firms forced to increase board independence did experience a drop in the rate of accounting fraud
 - About 2.8 percentage points
- Firms forced to adopt a fully independent audit committee did experience a drop in the rate of accounting fraud
 - About 2 percentage points
 - However, when examined jointly, only the increase in full board independence matters
- Firms forced to give up non-audit services from their auditor experienced no change in the rate of fraud



Takeaway

 The SOX-era governance reforms had some of their intended effect

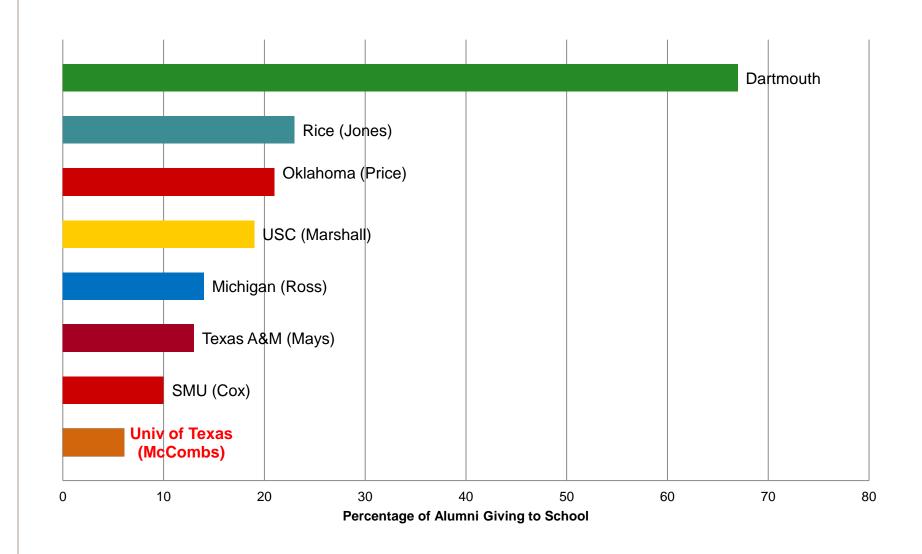


Thank you for your time!

• Questions?



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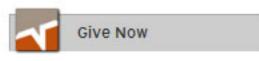
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